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87 T.C. 1-297

UNITED STATES TAX COURT

REPORTS

Vol. 87 No. 1

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July 1, 1986, to
July 31, 1986

UNITED STATES TAX COURT
WASHINGTON, D.C.

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sec. 318(a)(l)(A)(ii), A actually and/or constructively owned 100% of X stock before and after redemption (*United States v. Davis*, 397 U.S. 301); and (3) redemption was not complete redemption within meaning of sec. 302 (b)(3), since sec. 302(c)(2) did not prevent application of sec. 318(a)(l) attribution rules because A's continued employment with X after redemption was prohibited interest within meaning of sec. 302(c)(2)(A)(i) (*Seda v. Commissioner*, 82 T.C. 484, followed), so that redemption was taxable as dividend under sec. 301, rather than as payment in exchange for stock under sec. 302(a). ***Cerone v. Commissioner***........................ 1

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1979, each sister set up a Clifford trust, with herself as trustee, for each of her children, and transferred to these trusts undivided interests in her life estate, Court determined transfers made by petitioners were completed as of calendar year ended Dec. 31, 1975, for tax purposes, since petitioners parted with their entire interests in transferred property, their voting rights arose solely from fact that they were trustees of the various trusts, and they were subject to fiduciary constraints. *United States v. Byrum*, 408 U.S. 125, followed. *Chambers v. Commissioner*.................... 225

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issues to be presented in a fully stipulated case, and Commissioner refined the major thrust to one of his original grounds and raised new position or issue for the first time in his opening brief, that petitioners failed to compy with reg. 1.48-8(g)(3) by not attaching statement to returns, Court determined, under circumstances and in light of case law, that Commissioner's attempt to raise new position was untimely, since petitioners were surprised and their ability to present their case was prejudiced. *Leahy v. Commissioner* 56

Commissioner's Motion for Partial Summary Judgment and Petitioners' Motion for Summary Judgment—Efficacy of Waiver Extending Limitations—Adjustment to H's Share of "Recapture" Recomputation of Partnership's Investment Credit.—Where petitioners waived statutory limitations period for any adjustment to petitioner H's share of any item of credit of partnership in which H was a partner; language of waiver was identical, in part, to sec. 702(a)(7); deficiency was attributable to increase in tax under sec. 47, relating to disposition or cessation of use of property for which sec. 38 credit was allowed; and such adjustment pertained to H's partnership interest, Court determined (l) language of the waiver and sec. 702(a)(7) encompass investment credit authorized by sec. 38; (2) an adjustment to a credit includes a recomputation under sec. 47, and (3) Commissioner made requisite showing that there was no genuine issue of material fact as to efficacy of the waiver, so that Commissioner's motion for partial summary judgment was granted and petitioners' motion for summary judgement was denied. *Southern v. Commissioner* 49

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REPORTS
OF THE
UNITED STATES TAX COURT

MICHAEL N. CERONE AND HELEN E. CERONE, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STOCKADE CAFE, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1683-80, 1684-80, 28696-81, 27979-82.
Filed July 1, 1986.

P and his son were each 50 percent shareholders in C. Because of hostility between father and son, C redeemed all of P's stock therein. After the redemption, P continued to work as an employee of C for several years, but he retained no control over, and was not involved in the management of, the corporation after the redemption. *Held*, family hostility does not nullify the family attribution rules of sec. 318(a)(1), I.R.C. 1954, in determining whether the redemption satisfies the dividend equivalency test of sec. 302(b)(1), I.R.C. 1954, or the complete redemption test of sec. 302(b)(3), I.R.C. 1954. *David Metzger Trust v. Commissioner*, 76 T.C. 42 (1981) (Court-reviewed), affd. 693 F.2d 459 (5th Cir. 1982), cert. denied 463 U.S. 1207 (1983), followed. *Held, further*, under the attribution rules of sec. 318(a)(1)(A)(ii), I.R.C. 1954, P actually and/or constructively owned 100 percent of C's stock both before and after the redemption, and the redemption was thus essentially equivalent to a dividend within the meaning of sec. 302(b)(1), I.R.C. 1954. *United States v. Davis*,

397 U.S. 301, 307 (1970). *Held, further*: P's position as an employee of C after the redemption is a prohibited interest within the meaning of sec. 302(c)(2)(A)(i), I.R.C. 1954, so that sec. 302(c)(2), I.R.C. 1954, does not prevent the application of the attribution rules of sec. 318(a)(1), I.R.C. 1954, in testing the redemption under sec. 302(b)(3), I.R.C. 1954. *Seda v. Commissioner*, 82 T.C. 484 (1984) (Court-reviewed), followed. Consequently, the redemption is not a complete redemption within the meaning of sec. 302(b)(3), I.R.C. 1954, and thus is taxable as a dividend under sec. 301, I.R.C. 1954, rather than as a payment in exchange for stock under sec. 302(a), I.R.C. 1954.

David E. Pavel, for the petitioners.
Leonard A. Hammes, for the respondent.

PARKER, *Judge*: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes as follows:

Docket No.	*Petitioner(s)*	*Taxable year(s) ending*	*Deficiency*
1683-80	Michael N. Cerone	Dec. 31, 1974	$12,742.00
	and Helen E. Cerone	Dec. 31, 1976	2,436.00
1684-80	Stockade Cafe, Inc.	Sept. 30, 1975	2,595.36
		Sept. 30, 1976	2,711.47
28696-81	Michael N. Cerone	Dec. 31, 1975	9,502.00
	and Helen E. Cerone		
27979-82	Michael N. Cerone	Dec. 31, 1977	2,726.00
	and Helen E. Cerone	Dec. 31, 1978	2,934.00
		Dec. 31, 1979	3,195.00

After concessions,[1] the issues for decision are as follows:

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[1] Petitioner Stockade Cafe, Inc., conceded that its taxable income for its taxable year ending Sept. 30, 1975, should be increased by the amount of $2,278 to reflect that claimed repair expenses in the amount of $2,092 were nondeductible capital expenditures and that claimed repair expenses in the amount of $186 were paid during a prior taxable year. In its petition, the corporate petitioner also alleged that if such claimed repair expenses were nondeductible capital expenditures, then respondent erred by not allowing petitioner an investment credit with respect thereto. Petitioner presented no evidence on this issue, nor did it argue the matter on brief. We need not address this issue because petitioner failed to meet its burden of proof and/or conceded the issue. See Rule 149(b), Tax Court Rules of Practice and Procedure.

In the statutory notice for 1974, respondent determined that petitioner Michael N. Cerone constructively received a $25,000 downpayment for his stock in the corporate petitioner during 1974. (Docket No. 1683-80.) In the statutory notice for 1975, respondent took the inconsistent position that petitioner received the payment during 1975. (Docket No. 28696-81.) On brief, respondent concedes that petitioner received the payment during 1975, and has therefore conceded the deficiency for 1974; however docket No. 1683-80 also involves a deficiency for the year 1976 which remains at issue.

(1) Whether distributions received by petitioner Michael N. Cerone from petitioner Stockade Cafe, Inc., in redemption of his stock in the corporation should be treated as being received in exchange for such stock under section 302(a)[2] or as dividends under sections 302(d), 301, and 316. Resolution of this issue depends on whether the redemption qualifies as being not essentially equivalent to a dividend under section 302(b)(1) or, alternatively, as a complete redemption of all of his stock under section 302(b)(3). These determinations in turn involve the family attribution rules of section 318(a)(1) in a context of family hostility.

(2) Whether petitioner Stockade Cafe, Inc., can deduct the portion of such distributions it designated as interest as such under section 163. The parties agree that resolution of the first issue is determinative of this issue.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners Michael N. Cerone and Helen E. Cerone (collectively, the individual petitioners) resided in Omaha, Nebraska, at the time they filed their petitions in this case, except that petitioner Michael N. Cerone resided in Gretna, Nebraska, at the time they filed the petition in docket No. 27979-82. Petitioner Stockade Cafe, Inc. (the corporation), a Nebraska corporation, had its principal office at 13325 Millard Avenue, Omaha, Nebraska, at the time it filed its petition in this case. The individual petitioners filed joint Federal individual income tax returns (Forms 1040) for the years 1974 through 1979 with the Internal Revenue Service Center in Ogden, Utah. The corporation filed Federal corporation income tax returns (Forms 1120) for its taxable years ending September 30, 1975 and 1976, with the Internal Revenue Service Center in Ogden, Utah.

In the years prior to 1963, petitioner Michael N. Cerone (petitioner or "Mike") and his son (Michael L. Cerone or "Mick") worked together as painting and decorating contractors.[3] In March of 1963, petitioner, his son, and their acquaintance, Dan Malone, purchased the assets (including appurtenant real estate and liquor license)[4] of a restaurant and bar (individually, the restaurant or the bar; collectively, the business) known as the Stockade Cafe. The business was located at 13325 Millard Avenue, in what was then Millard and is now part of Omaha, Nebraska. The three men operated the business as equal partners for approximately 1 year until Dan Malone withdrew from the partnership. Thereafter, petitioner and his son operated the business as equal partners.

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

On or about October 1, 1964, petitioner and his son organized petitioner Stockade Cafe, Inc. (the corporation), and transferred thereto the assets of the business (including appurtenant real estate and liquor license). They each purchased 50 shares of the corporation's common stock for $5,000. These shares were the only outstanding shares of stock in the corporation. Petitioner and his son also became the directors and the president and secretary/treasurer, respectively, of the corporation. They maintained their respective ownership interests in and positions with the corporation until at least November 7, 1974.

Throughout the period of joint ownership, petitioner and his son were both very actively involved in managing the business. Petitioner ran the cash register and supervised the waitresses in the restaurant. He had authority to sign the corporation's checks. For awhile, petitioner also ordered supplies for the business, but his son soon assumed that responsibility. Petitioner's son ran the restaurant's kitchen and the bar. He also kept the corporation's books. Petitioner and his son shared responsibility for major management decisions and for hiring and firing personnel.

During the years 1971 through 1974, the corporation paid petitioner an annual salary and bonus as follows:

Year	*Salary*	*Bonus*
1971	$13,800	$21,156
1972	13,200	23,452

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[3] However, for a few months during 1958, petitioner operated "a little hamburger joint" on South 24th Street, in what was then Millard and which in 1970 or 1971 became part of Omaha, Nebraska. He disposed of the business because he was losing money.

[4] The license is a class "C" liquor license, subject to annual renewal.

Year	*Salary*	*Bonus*
1973	$14,400	$27,758
1974	14,400	27,660

The corporation paid petitioner's son an annual salary and bonus during those years in amounts equal to those it paid petitioner.

Under the joint management of petitioner and his son, the business steadily grew. They expanded the facilities to accommodate this growth. Petitioner and his son completely remodeled the restaurant and the bar and also put in a new kitchen. By 1974, the corporation employed between 50 and 60 employees. Approximately 175 patrons could be seated in the restaurant. Between 60 and 70 patrons could be seated in the bar. The restaurant and the bar were usually open from 10 in the morning until 1 a.m.

Despite their success, petitioner and his son disagreed about the management and operation of the business. As the years went by, the conflicts between the two increased in frequency and intensity. They disagreed about a number of matters. Petitioner refused to follow operating rules for employees that his son had established and that the son and the other managers were trying to enforce. Petitioner frequently reinstated employees that Mick or another manager had dismissed or reprimanded. Since a large number of the corporation's employees worked only part time, Mick and the other managers thought it extremely important to establish well-defined rules for the employees and to rigidly adhere to those rules. Petitioner's failure to follow the rules in such circumstances increased the growing hostility between him and his son.

Petitioner and his son also argued over expanding the business' facilities. Mike wanted to go slow on expansion. Mick favored expansion on a much larger scale than did his father. In particular, they disagreed about the new kitchen they put in. After petitioner's son became the sole shareholder of the corporation, he had this kitchen completely remodeled to his satisfaction.

The greatest source of discord between Mike and Mick resulted from the father's gambling activities. For many years, Mike held big gambling games in a relatively large apartment[5] located on the second floor of the building[6] that housed the restaurant and the bar. Over the years the gambling games got larger to the point that nothing smaller than a $20 bill was on the table during the games. Twice, the Omaha vice squad raided the building in search of betting slips or other evidence of petitioner's gambling activities. During one such raid, members of the vice squad ransacked the upstairs apartment. They searched for betting slips in the office that was also located on the second floor of the building. They also asked petitioner's son to open the safe in the office, which he did, but they failed to find any evidence of gambling. As they left the premises, the frustrated vice squad members walked through the restaurant and the bar and pulled out the telephones.[7] Shortly after this raid, a representative of the Nebraska Liquor Control Commission visited petitioner's son and said to him, "Mick, you're going to have to get your father out of here or you ain't going to have no liquor license." Without a liquor license, both the restaurant and the bar business would have been ruined. After this, petitioner and his son "could not get along at all." Petitioner's son was deeply concerned about losing the liquor license.[8]

Sometime after the second vice squad raid and the informal liquor commission warning, in late 1973 or early 1974, Mick told his father that one of them should buy out the other's ownership interest in the corporation. Petitioner did not think he could run the business without his son. Therefore, petitioner tentatively agreed to allow the corporation to redeem his stock therein, but he and his son haggled about the price for several months.

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[5] Although petitioner may have lived in the apartment at some point, one of the corporation's managers, Eunice Marty Postma, (Eunice Postma) and her husband lived there during the time period in which the gambling games occurred.

[6] The building was approximately 70 years old. It had two floors. The restaurant and the bar were located on the first floor. An office used by petitioner's son in connection with the business and an apartment were located on the second floor. The entrance to the second floor was just inside the front door of the building, so that a person walking into the restaurant or the bar would walk past the upstairs door before reaching the restaurant or the bar.

[7] Twenty to twenty-five percent of the restaurant's business consisted of carryout orders that were phoned in by customers, and this business was briefly interrupted by this incident.

[8] This concern was reflected in the terms of the redemption agreement by which the corporation agreed to redeem petitioner's stock, subject to the granting of a renewed liquor license for the license year commencing May 1, 1975. As noted above, note 4 *supra*, the liquor license was subject to annual renewal.

Petitioner and his son hotly negotiated the terms of the redemption, especially the price petitioner would receive for his stock in the corporation. They met together with their attorney, Tom Kelley (Kelley), in Kelley's office between 6 and 8 times to negotiate the redemption. A number of these meetings ended with either Mike or Mick "blowing up" and walking out of the meeting. Sometimes, petitioner or his son would meet separately with Kelley to discuss the redemption. Although they both continued to work at the restaurant and the bar, petitioner and his son sometimes were not speaking to one another, and their relationship was volatile. Finally, after almost a year of negotiations, on November 7, 1974, petitioner and the corporation entered into an agreement (the redemption agreement)[9] whereby petitioner and the corporation agreed that the corporation would redeem petitioner's 50 shares of stock therein for $125,000. The $125,000 was to be paid $25,000 down; the balance of $100,000 was payable over 7 years in equal, semiannual installments due on the first day of May and December of each year, commencing on May 1, 1975, with interest at an annual rate of 6½ percent.

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[9] The redemption agreement provides as follows:

AGREEMENT

THIS AGREEMENT is entered into this 7 day of November, 1974, between MICHAEL N. CERONE, hereinafter called Seller, and STOCKADE CAFE, INC., a Nebraska corporation, hereinafter called Buyer, of the corporate stock of STOCKADE CAFE, INC.

The Stockade Cafe, Inc. owns and operates a bar and restaurant at 13325 Millard Avenue, Omaha, Nebraska, formerly known as Millard, Nebraska.

The parties to this agreement state that the total of the outstanding shares of stock in the corporation as of this date are: Michael N. Cerone, 50 Shares, and Michael L. Cerone, 50 shares.

The Seller agrees to sell to the Buyer, 10 shares of the stock of the corporation as of October 1, 1974, and the balance of 40 shares of the stock of the corporation as of May 1, 1975, under the following terms and conditions:

The total sum of $125,000.00, payable as follows: $25,000.00 down, receipt of which is hereby acknowledged, and the balance of $100,000.00 payable over a period of seven years in equal semi-annual payments due on May 1st and December 1st of each year, commencing on May 1, 1975, with interest at the rate of 6 1/2% per annum on the unpaid balance.

The Seller agrees not to compete in the liquor business within a five mile radius, and seller further agrees not to enter into the restaurant business in any manner within a ten mile radius of the Millard location set forth above for a period of five years. The five year period does not apply to the liquor business.

The Seller shall further be entitled to one half of the cash kept in savings accounts in the corporate name as of October 1, 1974, plus the amount of the yearly bonus for the year ending September 30, 1974, as directed to be paid in whatever manner by the advice of Hess & Boyle, accountants, in accordance with payments as received by the two stockholders in previous years as bonus and director fees.

The stock certificate shall be signed in blank on this date by the Seller and left in the office of Tom Kelley, attorney, in trust, to be delivered to the corporation on May 1, 1975.

This contract is subject to the granting of the Class C Liquor License to the corporation for the license year commencing May 1, 1975.

The Buyer shall further, on May 1, 1975, give a note to the Seller for the unpaid amount of the total of $100,000.00, and that as a part of the consideration of this sale, Michael L. Cerone shall personally guarantee said note.

The chicken recipe used by the corporation at its restaurant is its sole property, and the Seller agrees not to use this recipe without written permission of the corporation, nor will he disclose it to any other persons.

* * * * * * *

Petitioner and his son intended that the execution of the redemption agreement finalize their arrangement regarding the ownership of the corporation. It did not. Petitioner did not receive the $25,000 downpayment required[10] by the redemption agreement on the date it was signed. Petitioner's son did not bring to the November 7th meeting at Kelley's office a corporate check or any other means by which the corporation could pay petitioner the downpayment. Nevertheless, petitioner and his son (on the corporation's behalf) signed the redemption agreement on November 7, 1974. They agreed to handle the downpayment at the corporation's office.

Even after signing the redemption agreement, petitioner and his son continued to argue over its terms.[11] Thereafter, they had several meetings in which they tried to resolve their differences. At one such meeting on December 27, 1974, petitioner's son brought a corporate check in the amount of $25,000, which was dated that date, in hopes of completing the redemption. However, petitioner and his son started arguing again and did not consummate the redemp-

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The record does not establish when the above language in regard to the cash in the savings account was stricken out.

[10] The redemption agreement clearly contemplated the payment of a $25,000 downpayment at the time the redemption agreement was executed. It provided that the consideration for petitioner's stock would be: "The total sum of $125,000.00, payable as follows: $25,000.00 down, *receipt of which is hereby acknowledged.*" (Emphasis added.)

It is noted that the total purchase price represented $2,500 per share for petitioner's 50 shares. The $25,000 downpayment would have covered the 10 shares to be sold as of October 1, 1974, according to the terms of the redemption agreement.

[11] The subject of these arguments is not wholly clear. Kelley testified that he thought they mostly had to do with Mick's desire to get petitioner off the business' premises. However, it was apparent to the Court that Kelley had little or no personal knowledge as to what was going on between Mike and Mick at that time. For example, Kelley testified that it was his understanding that petitioner and Mick were living in the upstairs apartment during the negotiations. That was not the fact. Mick never lived in that apartment and Mike did not live there during the years before the Court. Eunice Postma lived in the apartment during the time period in which the gambling raids that precipitated the redemption took place. Kelley could not recall if these arguments concerned the language that was stricken from the redemption agreement. See note 9 *supra.*

tion. Finally, on January 16, 1975, the redemption was finalized. Mick gave petitioner the corporation's $25,000 check dated December 27, 1974, and a promissory note[12] in the amount of $100,000, which represented the balance of the purchase price. In return, petitioner delivered the stock certificate representing his stock in the corporation to Kelley. He also executed a document directing Kelley to deliver the stock certificate to the corporation on May 1, 1975, upon payment of the first installment due under the promissory note on that date.[13]

Although the record does not show exactly when, on or about January 16, 1975, petitioner resigned from his positions as president and director of the corporation. He also relinquished his managerial and check-signing authority. Petitioner's son became the corporation's president. Nancy J. Cerone (Nancy Cerone), then Mick's wife,[14] became the corporation's secretary and treasurer. She also became a director of the corporation.

Petitioner's managerial responsibilities were assumed by Nancy Cerone and Eunice Marty Postma (Eunice Postma). Nancy Cerone had been employed by the corporation since her marriage to petitioner's son in 1967. She had worked full time for the corporation during the 2- or 3-year period before the redemption. Eunice Postma had been employed by the corporation, and its predecessor restaurants at that location, for more than 20 years. After the redemption,

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[12] The promissory note was executed by petitioner's son in his capacity as president of the corporation and in his individual capacity. The promissory note provided as follows:

PROMISSORY NOTE Omaha, Nebraska January 16, 1975

For a valuabe [sic] consideration, receipt of which is hereby acknowledged, the undersigned, Stockade Cafe, Inc., a Nebraska corporation, and Michael L. Cerone personally, hereby promise to pay to Michael N. Cerone, or order, the sum of $100,000.00, payable over a period of seven years in equal semi-annual payments due on May 1st and December 1st of each year commencing May 1, 1975, with interest at the rate of 6 1/2% per annum on the unpaid balance. The maker shall have the right to pay any sum so long as it does not exceed $30,000.00 in any one year on principal, plus interest.

* * * * * * *

Petitioner insisted on this promissory note because he thought that it would be easier to sue on a note if payments thereunder were not made.

[13] Although the corporation was not to receive petitioner's stock until May 1, 1975, for convenience we refer to Jan. 1975, as the date the redemption occurred because the parties treated the redemption as being settled on that date and because petitioner relinquished control of his stock on that date. Whether the stock was redeemed on Jan. 16, 1975, or on May 1, 1975, is not determinative of any issue before the Court.

[14] Petitioner's son and Nancy Cerone were married from sometime during 1967 until January of 1983.

Nancy Cerone assumed responsibility for hiring and firing waitresses and other restaurant personnel, as well as some kitchen personnel. She prepared work schedules and the payroll. She also arranged substitutes for absent employees. Eunice Postma helped prepare work schedules and supervised other employees. Petitioner's son continued to handle the responsibilities he had before the redemption. Petitioner's son, Nancy Cerone, and Eunice Postma arranged their schedules so that one of them was always at the restaurant and bar.

The redemption agreement did not provide that petitioner would continue as an employee of the corporation after the redemption. At no time during the negotiations or consummation of the redemption did petitioner and his son enter into any other oral or written agreement that petitioner would continue as an employee of the corporation. Petitioner may have remained away from the restaurant for about a month after January 16, 1975. If so, then approximately 1 month after the redemption, Mick asked petitioner to come back and run the cash register in the restaurant.[15] Petitioner did so.[16]

Petitioner worked full time (between 30 and 40 hours each week) for the corporation in 1975, 1976, and 1977, and at least until sometime during 1978. Thereafter, he worked only part time, usually on Friday and Saturday nights. Petitioner continued to work part time for the corporation at least through 1979 and probably until 1980 or 1981.[17] He stopped working for the corporation after suffering a heart attack while on vacation in Texas.

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[15] The record does not indicate when petitioner stopped working for the corporation. In fact, it is not clear that he did. Portions of the testimony of petitioner and his son imply that petitioner stopped working for the corporation for a period of time and then returned to work approximately 1 month after the redemption, at the son's request. However, none of the witnesses, including petitioner, himself, directly testified that his employment ended and began again. In contrast, there was an abundance of direct testimony and documentary evidence that petitioner resigned from his corporate positions and abdicated his managerial and check-signing authority. Moreover, there was no diminution in petitioner's salary for 1974 and 1975, the years in which his employment might have been interrupted, from his salary for 1973 and 1976, the preceding and succeeding years.

[16] If petitioner or his son had known that petitioner's employment with the corporation after the redemption would create the issues involved in this case, petitioner would not have continued to work for the corporation. Petitioner did not need the job. He could have worked as a painting contractor, as he had before buying the business, and as he did after leaving the corporation's employ. Also, he was receiving the installment payments for his stock. However, the record does not indicate that petitioner or his son sought any tax advice in regard to structuring the transaction. Their attorney, Kelley, was not a tax lawyer, and at the trial he did not know what the tax issues were in this case.

[17] Petitioner testified that he worked part time for about his last 3 years with the corporation. Petitioner also testified that he worked for the corporation until "probably [19]80,

During 1975 through 1979, the corporation paid petitioner the following annual salaries:

Year	*Salary*
1975	$14,400
1976	14,400
1977	14,474
1978	5,541
1979	3,566

The corporation did not pay petitioner any bonuses during these years. The record does not indicate whether petitioner received any salary from the corporation in 1980 and 1981. See note 17 *supra*.

Throughout his employment after the redemption, petitioner's responsibilities primarily involved handling the cash register in the restaurant.[18] During that time period, petitioner's son suffered from a number of physical ailments. He had continuing back problems,[19] sometimes suffered severe migraine headaches, and also had high blood pressure. At some point, he became addicted to prescribed drugs.[20] These physical ailments sometimes caused petitioner's son to be absent from the business.[21] Nonetheless, at no time after the redemption did petitioner exercise any managerial authority in the restaurant or in the bar. Petitioner had no authority to hire and fire personnel nor did his son consult with him regarding any management decisions. When petitioner's son was absent, Nancy Cerone usually took over his responsibilities. Additionally, a number of kitchen employees became experienced enough that they could help with ordering food and other of his duties when petitioner's son was absent from work.

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[19]81, somewhere in there." He indicated that his tax returns would show the facts, but his returns for 1980 and 1981 are not in the record. On rebuttal, his son testified that petitioner stopped working for the corporation in the summer of 1979. We find as a fact that petitioner was employed by the corporation at least until the summer of 1979, and probably until 1980 or 1981, about coterminous with the period of the installment payments from the corporation. The son sold the business in 1982.

[18] Petitioner's son testified that petitioner "ran the cash register and the restaurant side" of the business. He also stated that petitioner's job was to "take the money in the cash register, and oh, seat people and so forth." However, Nancy Cerone testified that "petitioner just ran the cash register, and that's all he ever did." She also testified that "sometimes when you run the cash register, you may occasionally [seat people], but there is a hostess there to do that. That wouldn't have been his job, no." Nancy Cerone directly supervised petitioner and other aspects of the restaurant outside of the kitchen after the redemption. Petitioner's son was not directly involved in the day-to-day operations of the restaurant other than the kitchen and the bar. We find that petitioner's responsibilities primarily involved handling the cash register in the restaurant.

[19] Petitioner's son underwent back surgery in July of 1974. This surgery did not alleviate his back problems, although they did improve somewhat.

[20] This may not have occurred until after petitioner stopped working for the corporation. An earlier trial date for this case was postponed because petitioner's son had been hospitalized and was not available to testify at that time.

[21] Petitioner's son testified that he missed 2 or 3 days of work every once in a while but not that often. He stated that he was hospitalized only "a couple of times." Nancy Cerone testified that his health problems interfered with Mick's being active in the business "Quite a bit." However, she also stated that she could not say how many days he normally missed per

In early 1982, petitioner's son sold the business for over $1 million.[22] The operating assets of the business have been sold. However, the corporation has not yet been dissolved pursuant to Nebraska State law. It is retaining some of its assets until this case is concluded.

During the taxable years in issue, the corporation paid petitioner the following amounts pursuant to the redemption agreement and promissory note:

Date	*Payments designated[1] as principal*	*Payments designated as interest*
Jan. 16, 1975	$25,000.00	none
June 30, 1975	5,754.28	$3,250.00
Oct. 1975	5,941.19	3,062.99
May 1976	6,134.28	2,869.90
Oct. 1976	6,333.64	2,670.54
Total 1977	13,292.00	4,717.00
Total 1978	14,169.00	3,839.00
Total 1979	15,105.00	2,903.00

[1] The corporation and petitioner designated the payments as principal or interest. Although respondent stipulated to the amounts of the payments, he specifically disagreed with their designation as principal or interest.

On the Schedule D (Capital Gains and Losses) attached to their return for each year in issue, the individual petitioners reported as long-term capital gain, under the installment method, a portion of the total payments designated as principal that petitioner received from the corporation

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month because "some months he wasn't absent at all." Respondent seems to argue that petitioner was really running the business, because of the son's physical problems, but the record does not support any such contention.

[22] Petitioners have requested the Court to make detailed findings about the 1982 sale, but the son's sale is irrelevant to any issues before this Court. There is no suggestion by respondent that petitioner Michael N. Cerone benefited in any way from the son's 1982 sale of the business.

during such year. The amounts[23] so reported are as follows:

Year	*Long-term capital gain*
1975	$35,227
1976	11,969
1977	12,760
1978	13,602
1979	14,502

On the Schedule D attached to their 1975 return, the individual petitioners also included the following statement: "Taxpayer elects to report gain by using the installment method, and agrees to notify IRS if any stock is reacquired within 10 years." On the Schedule B (Dividend and Interest Income) attached to their return for each year in issue, the individual petitioners reported as interest income the total payments designated as interest that petitioner received during that year.

On its return for its taxable year ending September 30, 1975, the corporation claimed an interest deduction in the amount of $5,662. This amount includes the $3,250 payment designated as interest made to petitioner on June 30, 1975. On its return for its taxable year ending September 30, 1976, the corporation claimed an interest deduction in the amount of $7,722. This amount includes the $3,062.99 and $2,869.90 payments designated as interest made to petitioner in October of 1975 and May of 1976, respectively. On its returns for its taxable years ending September 30, 1975 through 1979, the corporation reported gross receipts, deductions for the salary of petitioner's son, and taxable income as follows:

TYE Sept. 30—	*Gross receipts*	*Son's salary*	*Taxable income*
1975	$665,839	$64,950	$61,470
1976	740,911	76,864	66,400
1977	807,198	105,720	53,583
1978	869,549	89,750	51,169
1979	914,260	115,002	34,168

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[23] These amounts were determined by applying petitioner's gross profit ratio on the redemption (96 percent) to the total payments designated as principal he received during the particular year. Petitioner determined his gross profit ratio by subtracting his basis in his stock ($5,000) from the total purchase price for his stock ($125,000) and then dividing the result ($120,000) by the total purchase price.

In statutory notices of deficiency dated November 5, 1979 (for 1974[24] and 1976), August 21, 1981 (for 1975), and August 26, 1982 (for 1977, 1978, and 1979), respondent determined that all of the payments designated as principal that petitioner received during the taxable years in issue were essentially equivalent to dividends and therefore constituted ordinary income rather than long-term capital gain. In a statutory notice of deficiency dated November 5, 1979, respondent determined that the corporation's redemption of petitioner's stock was not a sale but a distribution essentially equivalent to a dividend. He therefore disallowed the interest expense deductions claimed by the corporation for the payments designated as interest made during the corporation's taxable years ending September 30, 1975 and 1976.

OPINION

Petitioner Michael N. Cerone (petitioner or "Mike") and his son (Michael L. Cerone—the son or "Mick") owned and operated the Stockade Cafe (the corporate taxpayer herein), each owning 50 percent of the stock of the corporation. The father and son had a volatile relationship and frequently disagreed over management decisions. Over the years their disagreements became more serious, and finally they decided one of them should buy the other's interest in the business. Petitioner did not think he could run the business alone, so it was decided that the corporation would redeem all of his stock. After the redemption, petitioner worked at the Stockade Cafe for several years, but he did not exercise any control over the corporation. This case involves the tax treatment of the payments or distributions petitioner received for his stock. Specifically, the issue is whether the distributions are dividends under section 301(a)[25] taxable as ordinary income or payments in exchange for stock under section 302(a)[26] taxable as capital gain. The family attribution rules of section 318 play a prominent role in this determination.

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[24] See note 1 *supra.*

[25] Generally, a corporation's distribution of property to a shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution is a dividend. Secs. 301(a) and 301(c)(1). A distribution is a dividend to the extent it is made out of the corporation's earnings and profits. Sec. 316(a).

[26] Under sec. 302(a), if a corporation redeems its stock and the redemption satisfies the requirements of sec. 302(b)(1), (2), (3), *or* (4), then the redemption is treated as "payment in

To have the distributions treated as payments in exchange for stock under section 302(a), petitioner must bring himself within either section 302(b)(1) or section 302(b)(3). Section 302(b)(1) provides that "Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend." Section 302(b)(3) provides that "Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." These determinations involve the family attribution rules. According to section 302(c)(1), "Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section." Under section 318(a), certain individuals and entities are treated as owning stock actually owned by certain related individuals and entities. Specifically, under section 318(a)(1)(A)—

> An individual shall be considered as owning the stock owned, directly or indirectly, by or for—
>
> * * * * * * *
>
> (ii) his *children*, grandchildren, and parents. [Emphasis added.]

Unless petitioner can bring himself within some exception to this family attribution rule, he would own 100 percent of the stock of the Stockade Cafe both before and after the redemption. The statutory exception, section 302(c)(2), provides as follows:

> (A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—
>
> (i) immediately after the distribution the distributee has no interest in the corporation (*including an interest as officer, director, or employee*), other than an interest as a creditor,
>
> (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and
>
> (iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii)

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exchange for the stock," and may therefore be taxed as capital gain. If the redemption does not so qualify, then it is treated as a distribution of property subject to sec. 301 (i.e., as a dividend to the extent of the corporation's earnings and profits). Sec. 302(d).

> and to retain such records as may be necessary for the application of this paragraph.[27]
>
> [Emphasis added.]

Petitioner's first argument is that the family attribution rules of section 318(a)(1) should be ignored in determining whether the corporation's redemption of his stock satisfies the requirements of either section 302(b)(1) or section 302(b)(3). Without the attribution rules, petitioner says, the redemption satisfies both of those sections. Petitioner's position is that the hostility between him and his son negates or nullifies the family attribution rules of section 318(a)(1). Secondly, petitioner argues that even if the attribution rules apply, the redemption so reduced his economic interests or rights in and control over the corporation that the distribution was not essentially equivalent to a dividend within the meaning of section 302(b)(1).

Conversely, respondent argues that section 318(a)(1) clearly applies in determining whether the redemption satisfies the requirements of either section 302(b)(1) or section 302(b)(3). Respondent contends that under section 318(a)(1)(A)(ii) petitioner is treated as owning all of his son's stock in the corporation. Thus, both before and after the redemption, petitioner actually and/or constructively owned 100 percent of the corporation's stock. This, respondent continues, precludes the redemption from being not essentially equivalent to a dividend within the meaning of section 302(b)(1). Respondent also argues that petitioner's constructive ownership of his son's stock prevents the redemption from satisfying the complete termination of interest requirement of section 302(b)(3). Respondent maintains that there is only one other way the redemption could qualify under section 302(b)(3), that is, if petitioner satisfied the requirements of section 302(c)(2). In such a case, the attribution rules of section 318(a)(1) would not apply, and, the corporation's redemption of all of the stock petitioner actually owned would be a complete redemption within the meaning of section 302(b)(3). Petitioner cannot satisfy the requirements of section 302(c)(2), respondent insists, because petitioner retained an interest in the corporation as an employee in violation of section 302(c)(2)(A)(i).

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[27] Sec. 1906(b)(13)(A) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1834, 1976-3 C.B. (Vol. 1) 1, 310, amended sec. 302(c)(2) by substituting the word "Secretary" for "Secretary or his delegate." The change was effective as of Feb. 1, 1977.

I. Family Hostility and the Attribution Rules

Petitioner vigorously argues that the hostility between him and his son should negate or nullify the family attribution rules of section 318(a)(1) in determining whether the corporation's redemption of his stock qualifies for sale or exchange treatment under section 302(b)(1) or section 302(b)(3). Petitioner stresses that the disagreements between him and his son, the corporation's two equal shareholders, increased in frequency and intensity as the years went by. Petitioner also emphasizes that he and his son began negotiating the redemption only after the Omaha vice squad raided the corporation's premises searching for evidence of petitioner's gambling activities, and a representative of the Nebraska Liquor Control Commission warned the son that petitioner might cause the corporation to lose its liquor license. Petitioner points to the numerous heated arguments he had with his son throughout the approximately 1-year period during which they negotiated the redemption agreement. He notes that those arguments continued even after the redemption agreement was signed. He further notes that the redemption was not consummated until approximately 2 months after the signing of the agreement.

Respondent's primary position[28] is that the discord between petitioner and his son does not affect petitioner's constructive ownership of his son's 100-percent interest in the corporation after the redemption. For the reasons stated below, we agree that there is no family hostility exception in this case to the section 318 family attribution rules.

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[28] Respondent questions whether petitioner and his son exaggerate the hostility that existed between them before the redemption. The Court is inclined to think that they do. Respondent points to their long working relationship. They had worked together for some 12 years before the redemption and continued to work together for at least 5 years after the redemption. Respondent also notes that petitioner did not want to run the corporation's business without his son's help. Clearly, the relationship between Mike and Mick was always volatile and because of Mike's gambling activity had become more so the year before the redemption. The father and son continued to work together during the redemption negotiations, although they were not speaking to each other at times. Thus, we have no doubt that there were arguments and some degree of hostility between petitioner and his son prior to the redemption. Whether this hostility was such as to bring into operation any "family hostility" exception to the attribution rules, we need not decide in this case. For purposes of this case, we assume the existence of the requisite degree of family hostility whatever that may be.

In making his family hostility argument, petitioner acknowledges, as he must, the importance of the Supreme Court's decision in *United States v. Davis*, 397 U.S. 301 (1970). In *Davis*, the Supreme Court held that: (1) The constructive ownership rules of section 318 apply to dividend equivalency determinations under section 302(b)(1); (2) redemptions of stock held by a sole shareholder, including a "constructive" sole shareholder, are always essentially equivalent to a dividend under section 302(b)(1); (3) business purpose is irrelevant in determining dividend equivalency under section 302(b)(1); and (4) in order to avoid dividend equivalency, the redemption must result in a "meaningful reduction" in the shareholder's proportionate interest in the corporation. See, e.g., *Roebling v. Commissioner*, 77 T.C. 30, 50-51 (1981); *Metzger Trust v. Commissioner*, 76 T.C. 42, 52-53 (1981) (Court-reviewed), affd. 693 F.2d 459 (5th Cir. 1982), cert. denied 463 U.S. 1207 (1983); *Benjamin v. Commissioner*, 66 T.C. 1084, 1106 (1976), affd. 592 F.2d 1259 (5th Cir. 1979); *Grabowski Trust v. Commissioner*, 58 T.C. 650, 656 (1972).[29] The Supreme Court made it clear that the attribution rules of section 318 are to be taken into account in determining whether a redemption is essentially equivalent to a dividend. *United States v. Davis*, 397 U.S. at 305-307.

Petitioner correctly observes that the facts in *Davis* did not involve family discord. Thus, the Supreme Court was not required to decide what effect, if any, family hostility has on the application of the attribution rules in the context of section 302. Petitioner cites *Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975), vacating and remanding 61 T.C. 398 (1973) and 62 T.C. 145 (1974) (supplemental opinion), as authority for the proposition that family hostility may negate or nullify the attribution rules of section 318 in determining whether a redemption satisfies the requirements of section 302(b)(1) or section 302(b)(3). In *Haft Trust*, the taxpayer-trusts argued that the attribution rules of section 318(a)(1) should not apply when hostility exists among the members of a family. *Haft Trust v. Commis-*

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[29] See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 9.24, at 9-29 to 9-34 (4th ed. 1979).

sioner, 61 T.C. at 403. We rejected that argument, analyzing the issue as follows:

> A careful review of the opinion of the Supreme Court in *Davis* convinces us that the petitioners' argument is inconsistent with the statements and rationale of that opinion. Before the enactment of the 1954 Code, the attribution rules were sometimes applied, and sometimes not applied; to avoid that uncertainty, section 302 expressly made the attribution rules applicable for purposes of determining whether a distribution in redemption should be treated as a dividend. H. Rept. No. 1337, 83d Cong., 2d Sess., p. A96 (1954). The Court relied upon "the plain language of the statute" in concluding that the attribution rules were applicable. 397 U.S. at 306. The Court was obviously convinced that in enacting the rules of section 302, Congress sought to provide definite and specific rules and to avoid the uncertainties which had arisen under the earlier law. * * *
>
> If the applicability of the attribution rules depended upon the feelings or attitudes among the members of a family, it would then be necessary to inquire into whether there was hostility or animosity among them, whether such discord was serious, and whether it would actually or likely impair the ability of one member of the family to influence the conduct of other members. By the terms of the statute, the attribution rules are applicable irrespective of the personal relationships which exist among the members of a family, and an interpretation of the statute which made their applicability depend upon whether there was discord among the members of the family—or the extent of any such discord—would frustrate the legislative objective and would be clearly inconsistent with the language and the rationale of *Davis*. * * * [*Haft Trust v. Commissioner*, 61 T.C. at 403.]

On appeal, the First Circuit analyzed the law differently. The First Circuit construed *Davis* as not requiring that the dividend equivalency inquiry end after taking into account the attribution rules. It pointed out that section 1.302-2(b), Income Tax Regs., only requires that constructive stock ownership caused by section 318 be one of the facts considered in determining dividend equivalency. The First Circuit interpreted *Davis*' meaningful reduction requirement as permitting, if not mandating, an examination of the facts and circumstances to determine the effect of the transaction going beyond a mere mechanical application of the attribution rules. *Haft Trust v. Commissioner*, 510 F.2d at 47, 48. The First Circuit believed that, by retaining the section 302(b)(1) dividend equivalency test as an alternative to the more objective tests of section 302(b)(2) and section 302(b)(3), Congress showed itself willing to tolerate some administrative and judicial inconvenience brought about inquiries into "the uncertain shifting quagmires of fami relationships" for the sake of taxpayer equity. *Haft Trust* *Commissioner*, 510 F.2d at 48. On the basis of its analys the First Circuit vacated our decision and remanded t case for reconsideration of the taxpayer-trusts' claims light of the facts and circumstances of the case, includin the existence of family discord tending to negate t presumption that the taxpayers would exert continuin control over the corporation despite the redemption. *Ha* *Trust v. Commissioner*, 510 F.2d at 48.

In further support of his family hostility position, pet tioner also points to a statement we made in a footnote i *Chertkof v. Commissioner*, 72 T.C. 1113 (1979), affd. 64 F.2d 264 (4th Cir. 1981). The primary issues in that cas were the fair market value of a corporate distribution to th taxpayer in redemption of his stock, and whether th redemption constituted a complete redemption under sectio 302(b)(3). Alternatively, the taxpayer argued that the redemption qualified under section 302(b)(1) as being no essentially equivalent to a dividend. In a footnote addressing this issue, *Chertkof v. Commissioner*, 72 T.C. a 1122-1123 n. 3, we first determined that under the attribution rules of section 318(a)(1)(A)(ii), the taxpayer was the sole shareholder of the redeeming corporation both before and after the redemption. After noting that according to *United States v. Davis*, 397 U.S. at 307 "such a redemption is always 'essentially equivalent to a dividend' " (fn. ref. omitted), we made the following statement upon which petitioner relies:

> Furthermore, we recognize that under certain limited circumstances, hostile family relationships have been held to block stock ownership attribution under sec. 318(a)(1) from one family member to another. *Robin Haft Trust v. Commissioner*, 510 F.2d 43, 47-48 (1st Cir. 1975), vacating and remanding 61 T.C. 398 (1973), supplemental opinion, 62 T.C. 145 (1974); *Benjamin v. Commissioner*, 66 T.C. 1084, 1107-1108 (1976); *Estate of Squier v. Commissioner*, 35 T.C. 950 (1961); *Parker v. Commissioner*, T.C. Memo. 1961-176. * * * [*Chertkof v. Commissioner*, 72 T.C. at 1123 n. 3.]

We found that the taxpayer's relationship with his father was not sufficiently hostile to prevent the attribution of his father's stock to him. Consequently, the taxpayer failed the dividend equivalency test of section 302(b)(1). *Chertkof v. Commissioner*, 72 T.C. at 1123 n. 3.

Relying on the First Circuit's opinion in *Haft Trust* and our acknowledgement thereof in *Chertkof*, petitioner asserts that the attribution rules should not apply herein because the hostility between him and his son precluded petitioner from exercising any control over the corporation after the redemption. However, after the opinions in *Haft Trust* and *Chertkof*, this Court once again analyzed the role of family hostility in the application of the attribution rules and respectfully declined to follow the First Circuit's approach. *Metzger Trust v. Commissioner*, 76 T.C. 42 (1981) (Court-reviewed), affd. 693 F.2d 459 (5th Cir. 1982), cert. denied 463 U.S. 1207 (1983). Petitioner in essence is asking us to reconsider the majority opinion in *Metzger Trust* and to adopt instead an approach suggested in Judge Tannenwald's concurring opinion in that case.

In *Metzger Trust*, the taxpayer-trust relied upon the First Circuit's opinion in *Haft Trust v. Commissioner, supra*, for the proposition that family hostility is a factor to be considered in mitigation of the attribution rules of section 318 in determining dividend equivalency under section 302(b)(1). We again analyzed the legislative history of section 318, and concluded that the end product of the legislative process, the statute itself, makes application of the attribution rules mandatory. *Metzger Trust v. Commissioner*, 76 T.C. at 56-58. We stated as follows:

> The language of the statute is clear. Courts do not have the power to repeal or amend the enactments of the legislature even though they may disagree with the result; rather, it is their function to give the natural and plain meaning to the statutes as passed by Congress. *National Life & Accident Insurance Co. v. United States*, 524 F.2d 559, 560 (6th Cir. 1975); *International Trading Co. v. Commissioner*, 484 F.2d 707, 713 (7th Cir. 1973); *Busse v. Commissioner*, 479 F.2d 1147, 1152 (7th Cir. 1973). Some commentators have suggested that it would be better to ignore the attributions rules where family discord is present. But courts should not attempt to rewrite statutes because they feel that the scheme Congress created could be improved upon. *United States v. Calamaro*, 354 U.S. 351, 357 (1957).
>
> It is not the function of a Court to rewrite or amend a statute in the guise of construing it. It is the Court's duty to construe and apply the statute as it is written; and if this results in inequity to certain

> taxpayers, the fault lies in the statute itself and is beyond the power of the Court to correct. *Farmers Tractor & Equipment Co. v. United States*, 224 F. Supp. 391 (E.D. Ark. 1963), appeal dismissed 326 F.2d 971 (8th Cir. 1964). * * * Our judicial function is limited to applying statutes on the basis of what Congress has written, not what Congress might have written. *Youakim v. Miller*, 562 F.2d 483, 487 (7th Cir. 1977).
>
> Although section 318 assumes * * * a "unity of action and of interest within the family which is frequently lacking," a Court should not make an exception to a statutory rule on the basis of that Court's determination that Congress established the rule on the basis of a faulty set of assumptions. *In re Continental Investment Corp.*, 586 F.2d 241 (1st Cir. 1978). [*Metzger Trust v. Commissioner*, 76 T.C. at 59-60. Fn. ref. omitted.]

Although we rejected the taxpayer-trust's argument that family discord could preclude application of the attribution rules, we nonetheless noted that family discord does have a role, albeit a limited one, in testing for dividend equivalency under section 302(b)(1). We reasoned that under *United States v. Davis, supra*, the proper analysis is as follows: First, the attribution rules are plainly and straightforwardly applied. Second, a determination is made whether there has been a reduction in the stockholder's proportionate interest in the corporation. If not, the inquiry ends because, if there is no change in the stockholder's interest, dividend equivalency results. If there has been a reduction, then all the facts and circumstances must be examined to see if the reduction was meaningful under *United States v. Davis, supra*. It is at this point, *and only then*, that family hostility becomes an appropriate factor for consideration. *Metzger Trust v. Commissioner*, 76 T.C. at 61.[30]

The Fifth Circuit affirmed our decision in *Metzger Trust* and the Supreme Court denied certiorari. *Metzger Trust v. Commissioner*, 693 F.2d 459 (5th Cir. 1982), affg. 76 T.C. 42 (1981), cert. denied 463 U.S. 1207 (1983). After analyzing the *Davis* and *Haft Trust* decisions, and the legislative history of section 302(b)(1), the Fifth Circuit concluded as follows:

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[30] In *Metzger Trust v. Commissioner*, 76 T.C. 42 (1981) (Court-reviewed), affd. 693 F.2d 459 (5th Cir. 1982), cert. denied 463 U.S. 1207 (1983), we used the fact patterns of two revenue rulings as convenient vehicles to illustrate the proper role of family discord in a dividend equivalency determination. Rev. Rul. 75-502, 1975-2 C.B. 111, and Rev. Rul. 76-364, 1976-2 C.B. 91. See 76 T.C. at 63-64. We need not repeat that analysis here, but these examples clearly illustrate one situation where we have indicated that family hostility is relevant to the dividend equivalency determination.

> In summary, we believe that the Commissioner and Tax Court were correct in refusing to take family discord into account in applying the attribution rules. When a question is raised as to the dividend equivalency of a redemption, under §302(b)(1) the correct approach is to apply the attribution rules *first*, then to determine whether there has been "a meaningful reduction of the shareholder's proportionate interest," without regard to whether the interest is actually or constructively held. What is "meaningful" then, to borrow a word, is essentially an inquiry into structure, a structure that applies statutorily dictated rules of economic unity. [*Metzger Trust v. Commissioner*, 693 F.2d at 467-468. Emphasis in original; fn. ref. omitted.]

Both this Court's opinion and the Fifth Circuit's opinion in *Metzger Trust* clearly demonstrate that family hostility does not prevent application of the attribution rules. At most, as we suggested in *Metzger Trust*, family hostility comes into play only in determining, *after the attribution rules have been applied*, whether any reduction in stock ownership is meaningful.[31] Nevertheless, petitioner argues that we should abandon the rationale of those opinions, citing Judge Tannenwald's concurring opinion in our *Metzger Trust* case. *Metzger Trust v. Commissioner*, 76 T.C. at 80. While he also concluded that the attribution rules were applicable in *Metzger Trust*, Judge Tannenwald's rationale for that result differed from that of the majority. Reasoning that there was no hostility in any link in the chain of attribution,[32] Judge Tannenwald concluded as follows:

> Thus, all of the attribution rules relevant to the instant case accord with reality, and so their application herein is consistent with the rationale behind section 318. We need not decide whether we may or should

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[31] The Fifth Circuit did not, however, embrace our suggestion that family hostility may be a factor in determining whether a reduction in the stockholder's interest in the redeeming corporation is meaningful. In a footnote, that Court stated as follows:

> "The Tax Court in its opinion below did suggest that in cases of non-pro-rata distribution family hostility 'can be a relevant fact to be considered in determining whether the reduction in the shareholder's interest is meaningful so as to qualify the distribution as not essentially equivalent to a dividend under section 302(b)(l).' 76 T.C. 42, 62-63 (1981). That notion is inconsistent with our approach. Regardless, such a case was not presented below or here." [*Metzger Trust v. Commissioner*, 693 F.2d 459, 467 n. 16 (5th Cir. 1982), affg. 76 T.C. 42 (1981), cert. denied 463 U.S. 1207 (1983).]

Similarly, this case does not involve a non-pro-rata distribution. There are only two shareholders, father and son, and under the family attribution rules, the father owns 100 percent of the stock both before and after the redemption.

[32] The chain of attribution in *Metzger Trust* ran from child's trust to child to father to taxpayer-trust. The only hostility present existed between the father and his sisters, to whom the attribution rules did not apply. See *Metzger Trust v. Commissioner, supra*, 76 T.C. at 83.

> ameliorate the application of the section 318 rules if justice would served thereby, and I believe that a proper respect for the judici function and its inherent limitations requires that we do not decide the questions before they are properly presented. [*Metzger Trust v. Commi sioner*, 76 T.C. at 83.]

Judge Tannenwald also commented on the majority' suggestion that family hostility may be considered only i determining whether a reduction in stock ownership i meaningful; that is, only *after* the attribution rules hav been applied, the redemption resulted in a reduction i stock ownership, and the only remaining question i whether such reduction is meaningful. He suggested tha this order of analysis "paves a road for objectionabl arbitrary results." *Metzger Trust v. Commissioner,* 76 T.C at 84. To illustrate his point, Judge Tannenwald posited th following hypothetical:

> Suppose a father and son jointly own a corporation until they have bitter dispute, at which time the son is completely redeemed. If, befor the redemption, they owned in the aggregate 100 percent of th corporation's outstanding stock, they each will be deemed to own 10 percent of the corporation after the redemption. Thus, the rule which th majority feels compelled to adopt would treat the redemption a essentially equivalent to a dividend under section 302(b)(1). However, if third party (say, an employee) owned as little as 1 share, the redemptio would reduce percentage-wise the son's constructive ownership ever s slightly below that of his previous actual and constructive ownership and thus he would now be free under the majority's rule to argue tha the attribution rules should be overlooked because of the family feud Yet, it seems clear to me that whether or not a third party owns minimal amount of stock has nothing whatsoever to do with the issue. * * [*Metzger Trust v. Commissioner*, 76 T.C. at 84. Fn. ref. omitted.]

Petitioner points to Judge Tannenwald's example in support of his argument that the attribution rules should not be applied in this case because the result is objectionably arbitrary. With all due respect to our esteemed colleague, we considered but declined to follow those arguments in *Metzger Trust.* Having respect for the principle of stare decisis, we see no reason to revisit that case.

We acknowledged in *Metzger Trust v. Commissioner,* 76 T.C. at 64, that application of the attribution rules can produce harsh results in certain circumstances. We noted that such was the case in *United States v. Davis,* 397 U.S.

301 (1970). However, we also observed (76 T.C. at 64) that "the Supreme Court has been unwilling to reconsider the harsh effects of the *Davis* decision (*Albers v. Commissioner*, 414 U.S. 982 (1973) (denying certiorari)), thus, we must follow the law." (Fn. ref. omitted.) Moreover, whatever the result in a case involving the facts of Judge Tannenwald's hypothetical, this is not the case.[33] Thus, the hostility between petitioner and his son simply has no effect on the application of the section 318 attribution rules or on our decision in this case.

II. Section 302(b)(1)—Dividend Equivalency Test

Applying the analysis set forth in *Metzger Trust v. Commissioner, supra*, for determining dividend equivalency under section 302(b)(1) to the facts of this case, we reach the following conclusions: Under the attribution rules of section 318(a)(1)(A)(ii), petitioner owned 100 percent of the corporation's outstanding stock both before and after the redemption. Before the redemption, petitioner directly owned 50 shares. He also constructively owned, under section 318(a)(1)(A)(ii), the 50 shares actually owned by his son. After the corporation redeemed the 50 shares petitioner actually owned, he still constructively owned his son's 50 shares, which then constituted all of the corporation's outstanding stock. Because petitioner is treated as owning 100 percent of the corporation's stock both before and after the redemption, the redemption did not cause any reduction in petitioner's proportionate interest in the corporation. Therefore, the redemption was essentially equivalent to a dividend within the meaning of section 302(b)(1). *Metzger Trust v. Commissioner*, 76 T.C. at 61. As the Supreme Court stated in *United States v. Davis*, 397 U.S. at 307:

> After application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation. We conclude that such a redemption is always "essentially equivalent to a dividend" within the meaning of that phrase in §302(b)(1) * * *

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[33] To keep his hypothetical simple, Judge Tannenwald did not consider the possible effect of the provisions of sec. 302(c)(2). 76 T.C. at 64 n. 6. Here sec. 302(c)(2)(A) is involved and will be discussed in the text below.

Despite this clear result, petitioner nevertheless argues that even after applying the attribution rules of section 318, we should find that the redemption was not essentially equivalent to a dividend. To support this position, petitioner begins by quoting the following language from section 1.302-2(b), Income Tax Regs:[34]

> The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. *One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a).* * * * [Emphasis added.]

Petitioner also cites the following passages from *United States v. Davis*, 397 U.S. 301, 311, 313 (1970):

> The intended scope of §302(b)(1) as revealed by this legislative history is certainly not free from doubt. However, we agree with the Government that by making the sole inquiry relevant for the future the narrow one *whether the redemption could be characterized as a sale*, Congress was apparently rejecting past court decisions that had also considered factors indicating the presence or absence of a tax-avoidance motive. * * *
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> * * * * *
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> If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders *without a change in the relative economic interests or rights of the stockholders.* Where a redemption has that same effect, it cannot be said to have

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[34] Petitioner also points to section 1.302-2(c), Income Tax Regs. It provides as follows:

"In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. * * *"

Petitioner contends that this provision supports a finding that the redemption was not essentially equivalent to a dividend. His rationale is that under the regulation if a redemption is treated as a dividend distribution, the taxpayer is entitled to adjust the basis of any remaining stock to reflect the basis of the redeemed stock. The corporation redeemed all of the stock petitioner actually owned. Therefore, petitioner contends, he will not be able to reflect such basis in other stock *as required by the regulation*. Moreover, petitioner complains that he will lose forever his $5,000 basis in the redeemed stock. However, just this type of situation is contemplated by example (2) of sec. 1.302-2(c), Income Tax Regs. It provides as follows:

"H and W, husband and wife, each own half of the stock of Corporation X. All of the stock was purchased by H for $100,000 cash. In 1950 H gave one-half of the stock to W, the stock transferred having a value in excess of $50,000. In 1955 all of the stock of H is redeemed for $150,000, and it is determined that the distribution to H in redemption of his shares constitutes the distribution of a dividend. Immediately after the transaction, W holds the remaining stock of Corporation X with a basis of $100,000."

Thus, petitioner's basis in his redeemed stock will not be lost forever. Rather, it will be reflected in an adjustment to the basis of his son's stock in the corporation in accordance with sec. 1.302-2(c), Income Tax Regs.

> satisfied the "not essentially equivalent to a dividend" requirement of §302(b)(1). * * *
>
> [Emphasis added; fn. ref. omitted.]

Finally, petitioner reminds us of the following statement made in *Haft Trust v. Commissioner*, 510 F.2d at 48:

> The effect of the transaction rather than its motivation is determinative. Section 302(b)(l) requires a "*meaningful reduction* of the shareholder's proportionate interest in the corporation," *id.* [*United States v. Davis, supra*, 397 U.S. at 313.] (emphasis supplied.) This language certainly seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules.

Petitioner concludes from these passages that even if the attribution rules apply, and he is therefore treated as owning 100 percent of the corporation's stock both before and after the redemption, we must nevertheless analyze the redemption to determine if it was essentially equivalent to a dividend. According to petitioner, the real question is whether the redemption should be characterized as a sale. He further maintains that in analyzing the redemption we must consider the effect it had on petitioner's economic interests or rights in and control over the corporation.

Petitioner observes that before the redemption, he actually owned 50 percent of the corporation's outstanding stock. Thus, petitioner enjoyed all of the benefits of actual ownership of the corporation. He directly benefited from increases in the corporation's value. Petitioner was also an officer and director of the corporation. Before the redemption, petitioner received total salaries and bonuses ranging from $34,956 in 1971 to $42,060 in 1974. Petitioner also played an active role in managing the corporation's business.

After the redemption, petitioner did not actually own any of the corporation's stock. Thus, he did not receive any of the benefits of actual ownership of the corporation. Increases in the corporation's value no longer inured to his benefit. He resigned from his office and directorship. After the redemption, petitioner's salary as an employee ranged from $14,400 in 1975 to $3,566 in 1979. Petitioner no longer had any voice in management decisions.

Petitioner argues that this drastic reduction in his economic interests or rights in and control over the corporation constitutes a meaningful reduction of his proportionate interest in the corporation. According to petitioner, it fully justifies characterizing the redemption as a sale. Thus, petitioner continues, the redemption was not essentially equivalent to a dividend within the meaning of section 302(b)(1) despite the attribution rules.

The test for dividend equivalency is whether there has been "a meaningful reduction of the *shareholder's proportionate interest* in the corporation." *United States v. Davis*, 397 U.S at 313. (Emphasis added.) Thus, we must analyze petitioner's relative economic interests or rights in the corporation *as a shareholder*. As discussed at length, *supra*, we must treat petitioner as if he actually owned the 50 shares his son owned after the redemption. In so doing we must attribute to petitioner all of the economic interests or rights in the corporation represented by his son's 50 shares. To do otherwise would, in effect, ignore petitioner's constructive ownership of those shares. As we said in *Metzger Trust v. Commissioner*, 76 T.C. at 61-62:

> To treat constructively owned stock different from actually owned stock for section 302(b)(1) purposes would be the same as ignoring the attribution rules in the first place. This is clearly contrary to the plain meaning of the statute and its legislative history.

Under the attribution rules of section 318, petitioner is treated as owning 100 percent of the corporation's stock both before and after the redemption. He is also treated as having the economic interests or rights represented by such stock. Thus, there was no reduction in his proportionate interest as a shareholder in the corporation. Moreover, we think the following observations from *Metzger Trust v. Commissioner*, 76 T.C. at 62, dispose of petitioner's argument that his loss of control over the corporation can help satisfy the meaningful reduction requirement:

> Some cases and commentators suggest that where family hostility exists, the concept of "interest" in a corporation can be broken down into two components, ownership and control, for purposes of applying or not applying the attribution rules in determining dividend equivalency. Under such a theory a stockholder, who before the redemption owned 100 percent of a corporation, actually, and who after the redemption owned

> no stock, actually, but 100 percent, constructively, could be deemed to have no control over the corporation where the remaining shareholders were unfriendly section 318 relatives or entities. Because his "control" of the corporation went from 100 percent to nothing, the shareholder, according to the theory, had a meaningful reduction in his "interest" in the corporation. This, in effect, ignores the constructively owned stock for the purposes of determining dividend equivalency contrary to the statute, the regulations, the legislative history, and the rule of *Davis*. *Niedermeyer v. Commissioner*, 62 T.C. 280, 285-86 (1974), affd. 535 F.2d 500 (9th Cir. 1976), cert. denied 429 U.S. 1000 (1976). Although the degree of control of a corporation is a factor to be considered in testing dividend equivalency (*Benjamin v. Commissioner*, 66 T.C. 1084 (1976), affd. 592 F.2d 1259 (5th Cir. 1979)), the final determination must take into account constructively owned stock as well as actually owned stock. Such a position is consistent with the effect of attribution in situations where there is no family discord and where the taxpayer, after the redemption, owned no stock, actually, but 100 percent, constructively. In such cases, courts have held the distribution to be essentially equivalent to a dividend. *Lewis v. Commissioner*, 35 T.C. 71 (1960); *Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967), affg. 47 T.C. 258 (1966). [Fn. ref. omitted.]

III. Section 302(b)(3)—Complete Redemption Test

This case presents the issue of the statutory exception of section 302(c)(2) to avoid the family attribution rules. Section 302(b)(3) provides that a complete redemption of all of the stock of a corporation owned by the shareholder qualifies for exchange treatment under section 302(a). Generally, section 302(c)(1) provides that the attribution rules apply in determining whether the requirements of section 302(b)(3) have been satisfied. However, under section 302(c)(2), the attribution rules of section 318(a)(1) do not apply in the case of a complete redemption under section 302(b)(3) if, inter alia, "immediately after the distribution the distributee has no interest in the corporation (*including an interest as officer, director, or employee*), other than an interest as a creditor." (Emphasis added.)

Petitioner argues that the redemption satisfied the complete termination of interest requirement of section 302(b)(3). His primary basis for this argument is that the attribution rules of section 318 should not apply because of the hostility between petitioner and his son. As discussed at length above, family hostility does not prevent application of the attribution rules. Thus, unless petitioner satisfies the requirements of section 302(c)(2), petitioner did not completely terminate his interest in the corporation as required by section 302(b)(3).

Respondent argues that there was no complete termination of petitioner's interest because petitioner was an employee of the corporation after the redemption. Thus, respondent contends, petitioner retained a prohibited interest in the corporation within the meaning of section 302(c)(2). According to respondent, this causes the attribution rules to apply (sec. 302(c)(1)), and precludes the redemption from being a complete redemption within the meaning of section 302(b)(3).

This Court recently examined the application of section 302(c)(2)(A)(i) in two cases, one involving an independent contractor and the other involving an employee. *Lynch v. Commissioner*, 83 T.C. 597 (1984); *Seda v. Commissioner*, 82 T.C. 484 (1984) (Court-reviewed). Earlier cases involving claims of a prohibited interest under section 302(c)(2)(A)(i) had involved an interest as an independent contractor or as something other than an officer, director, or employee of the corporation. *Chertkof v. Commissioner*, 72 T.C. at 1124 (interest under a management contract); *Estate of Lennard v. Commissioner*, 61 T.C. 554 (1974) (independent contractor providing accounting services to the corporation after the redemption). Our Court-reviewed opinion in *Seda v. Commissioner*, *supra*, is the only case in which this Court has squarely faced a claimed prohibited interest as an employee.

In *Seda*, the taxpayers owned all of the outstanding stock of B & B Supply Co. (B & B). The taxpayer-husband, Mr. Seda, was B & B's president and chairman of the board. The taxpayer-wife, Mrs. Seda, was a director, vice president, and secretary of B & B. Because of their deteriorating health, the taxpayers decided to have B & B redeem all of their stock therein. The taxpayers resigned from their positions as officers and directors the same day the redemption was effected. Pursuant to the redemption agreement, B & B also issued 1,000 shares of its stock to the taxpayers' son, who thus was the sole shareholder of B & B after the redemption. Mr. Seda, however, continued to work for B & B after the redemption at a monthly salary of $1,000. Approximately 2 years after the redemption, immediately after learning that his employment relationship could result in the gain from the redemption of his stock being taxed as ordinary income, Mr. Seda terminated his employment relationship with B & B. Mrs. Seda never served as an officer, director, or employee of B & B after the redemption.

In *Seda*, respondent argued that the taxpayers were not entitled to the relief from the family attribution rules provided by section 302(c)(2) because Mr. Seda remained an employee of B & B after the redemption. The taxpayers argued that section 302(c)(2)(A)(i) does not prohibit all employment relationships. They further contended that Mr. Seda's employment after the redemption was not the retention of a prohibited interest in B & B. We disagreed. In concluding that the taxpayers failed to satisfy section 302(c)(2)(A)(i), and that they therefore did not satisfy the requirements of section 302(b)(3) because of their constructive ownership of their son's stock, we stated as follows:

> This Court has previously stated that it is reasonable to infer from the legislative history that in enacting section 302(c)(2)(A) Congress was primarily concerned with a situation where a redeeming shareholder retained a financial stake in the corporation or continued to control the corporation and benefit by its operations after making only a nominal transfer of his stock. *Estate of Lennard v. Commissioner*, 61 T.C. 554, 561 (1974).
>
> Although section 302(c)(2)(A)(i) may not prohibit the retention of all employment relationships, *it is clear that the level of employment engaged in by Mr. Seda herein is prohibited.* After the redemption, Mr. Seda continued to work for the company for almost 2 years and received a salary of $1,000 per month. *By receiving that salary, Mr. Seda did retain a financial stake in the company.* Moreover, petitioners have failed to show that Mr. Seda ceased to be involved in the management of the company after the redemption. The fact that petitioners did not know that Mr. Seda's continued employment would prevent them from achieving long-term capital gain treatment is unfortunate, but not controlling. * * * [*Seda v. Commissioner*, 82 T.C. at 488. Fn. ref. omitted; emphasis added.]

Thus, we concluded that Mr. Seda's employment for almost a 2-year period gave him a financial stake in the company which constituted a prohibited interest under section 302(c)(2)(A)(i).[35]

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[35] Eight judges, in a concurring opinion, thought that in adopting the parenthetical language of sec. 302(c)(2)(A)(i), Congress intended to "prohibit the retention of all employment

Lynch v. Commissioner, supra, decided a few months after *Seda*, involved an independent contractor rather than an employee, but reaffirmed the rationale of *Seda*. The taxpayer-husband, Mr. Lynch, was originally the sole shareholder of W.M. Lynch Co. (the company). The taxpayers' son was employed by the company as a salesman. He was also elected a director and officer of the company. Later, Mr. Lynch sold some of his stock in the company to his son. The taxpayers resigned as directors and officers of the company. Shortly thereafter, the company redeemed the rest of Mr. Lynch's stock. At the same time, Mr. Lynch entered into a consulting agreement whereby he agreed to provide such consulting services of an advisory nature as the company might reasonably request. After the redemption, Mr. Lynch performed some services for the company pursuant to a consulting agreement. He received a monthly fee under the agreement. He also received other minor benefits from the company.

Asserting that the true nature of Mr. Lynch's relationship with the company was that of an employee, the Commissioner argued that Mr. Lynch had retained an interest in the company prohibited by section 302(c)(2)(A)(i). The taxpayers argued that under the consulting agreement, Mr. Lynch was merely an independent contractor. After carefully examining the relationship between the taxpayer-husband and the company after the redemption, we determined that the weight of the evidence established that he was *not* an employee of the company after the redemption. In light of that conclusion, we examined the facts and circumstances to determine whether Mr. Lynch had retained a financial stake in the company or continued to control the company after the redemption of his stock and ultimately concluded that he had done neither. 83 T.C. at 605-606, 608. We indicated that such an examination of the facts and circumstances was particularly required "where the interest retained is not that of an officer, director, or employee." 83 T.C. at 605.

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relationships." They would have applied the per se rule they considered mandated by the statute. The concurring judges questioned the majority's "insistence on judicially legislating this Court into the additional burden of inquiring into the level of employment." *Seda v. Commissioner*, 82 T.C. 484, 490-492 (1984) (Court-reviewed). See generally Rose, "The Prohibited Interest of Section 302(c)(2)(A)," 36 Tax L. Rev. 131 (1981).

Petitioner does not and cannot argue that he was not an employee of the corporation after the redemption of his stock, one of the categories of prohibited interest listed in the statute. Moreover, we conclude on the record as a whole that petitioner's employment relationship with the corporation after the redemption was a prohibited interest within the meaning of section 302(c)(2)(A)(i). *Seda v. Commissioner*, 82 T.C. at 488. Petitioner was employed by the corporation for some 5 and possibly up to 7 years after the redemption. See note 17 *supra*. He received an annual salary of $14,400 or more for the first 3 years. He received lesser amounts for the remaining years, after he began working part time. He stopped working for the Stockade Cafe only after he had suffered a heart attack. Petitioner's length of employment and salary level were greater than those involved in *Seda*. Thus, we find that he retained a financial stake in the corporation prohibited by section 302(c)(2)(A)(i). See *Seda v. Commissioner*, 82 T.C. at 488.

However, unlike the taxpayer in *Seda*, petitioner established that he did not continue to control the corporation after the redemption. See *Seda v. Commissioner*, 82 T.C. at 488. This fact alone does not prevent petitioner's employment relationship with the corporation from being of the type prohibited by section 302(c)(2)(A)(i). The test is whether he retained a financial stake *or* continued to control the corporation. See *Lynch v. Commissioner*, 83 T.C. at 605; *Seda v. Commissioner*, 82 T.C. at 488. Thus, on the facts of this case, section 302(c)(2) does not prevent the application of the attribution rules in testing the redemption under section 302(b)(3). Consequently, the corporation's redemption of petitioner's stock was not a complete redemption within the meaning of section 302(b)(3).

IV. Conclusion

The corporation's redemption of petitioner's stock failed to satisfy the requirements of either section 302(b)(l) or section 302(b)(3). Thus, the redemption must be treated as a distribution of property to which section 301 applies. See sec. 302(d). Under sections 301 and 316, a distribution of property is treated as ordinary income to the extent it is made out of the corporation's earnings and profits. Secs.

301(a), 301(c)(1), 316(a). Petitioners do not suggest that the corporation's payments to petitioner were not made out of its earnings and profits.[36] Consequently, all such payments are ordinary income to the individual petitioners, and the corporation is not entitled to deduct any portion of such payments as interest.

To reflect the foregoing holdings and the concessions by the parties,

Decision will be entered for petitioners for the year 1974, and for respondent for the year 1976 in docket No. 1683-80.

Decisions will be entered for respondent in docket Nos. 1684-80, 28696-81, and 27979-82.

WILLIAM T. EGOLF AND HARRYLOU EGOLF, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3640-83. Filed July 2, 1986.

P is the general partner of a limited partnership engaged in oil and gas drilling. Pursuant to the partnership agreement, P, as general manager, provides management services to the partnership in exchange for a management fee. P paid various organization and syndication costs of the partnership and claimed them as ordinary and necessary expenses of his lease management business. *Held*, the management fee P received is reimbursement for the organization and syndication expenses he paid on behalf of the partnership and he is not entitled to claim a deduction for those expenses. Sec. 709(a), I.R.C. 1954. *Held, further*, the partnership may not

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[36] Moreover, if petitioners wanted to make such an argument, we would have to hold that they failed to meet their burden of proof on this issue. *Cherthof v. Commissioner*, 72 T.C. 1113, 1126 n. 4 (1979), affd. 649 F.2d 264 (4th Cir. 1981); *Makransky v. Commissioner*, 36 T.C. 446, 453 (1961), affd. 321 F.2d 598 (3d Cir. 1963); Rule 142(a). The corporation's tax returns for its taxable years ending Sept. 30, 1975 through 1979, are in the record. Schedule L (Balance Sheets) to each such return discloses the corporation's retained earnings at the beginning and end of the relevant taxable year. Additionally, respondent requested that we find and we found as facts the corporation's taxable income for each such taxable year. However, neither the corporation's retained earnings nor its taxable income necessarily equals its earnings and profits. See sec. 312. See generally, B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 7.03, at 7-11 to 7-23 (4th ed. 1979). However, in view of the success of the business, it seems likely that there were sufficient earnings and profits to cover the distribution. In any event, petitioners have not argued or proved otherwise.

amortize the portion of the management fee representing reimbursement of organization and syndication expenses under sec. 167. Sec. 709(a), I.R.C. 1954. *Held, further,* overpayments of management fees were not loans and P may not exclude those amounts from income for the taxable years 1978 and 1979.

John J. Griffin, Sr. and *Laurence J. Whalen,* for the petitioners.

Manolo T. Rodriguez-Bird, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioners' Federal income taxes for the taxable years 1978 and 1979 in the amounts of $112,628.52 and $392,761.80, respectively. The issues for decision are: (l) Whether petitioner properly deducted as ordinary and necessary business expenses amounts paid by him representing partnership organization and syndication costs; (2) whether the partnership may amortize organization and syndication expenses; and (3) whether management fee payments received by petitioner in excess of the amount provided in the partnership agreement represented loans.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts, attached exhibits, and the supplemental stipulation of facts are incorporated by this reference.

Petitioners William T. and Harrylou Egolf,[1] husband and wife, timely filed joint Federal income tax returns for the taxable years 1978 and 1979 with the Internal Revenue Service Center at Austin, Texas. Petitioners filed an amended Federal income tax return (Form 1040X) for the taxable year 1979 on June 15, 1983. The Egolfs were residents of Oklahoma City, Oklahoma, at the time the petition was filed in this case.

Upon graduation from the University of Oklahoma in 1939, William T. Egolf (Egolf or petitioner) joined his father in the business of acquiring, developing, and operating oil and gas properties. He continued in this business after the death of his father in 1949. In 1969 he began organizing and promoting oil and gas drilling programs. In the course of this activity, he identified and obtained leases on several properties with the potential for the profitable production of oil and gas. Egolf then oversaw the drilling and the operation of the developed properties. He sponsored more than 30 such drilling programs between 1969 and 1984. Development of the properties acquired by Egolf was typically financed through the sale of limited partnership interests.

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[1] Petitioner Harrylou Egolf is a party solely as the result of filing a joint Federal income tax return with petitioner William T. Egolf for the taxable years in issue. References to petitioner in the singular will refer to petitioner William T. Egolf.

In the taxable year 1978, petitioner organized a drilling program that was financed by sales of limited partnership interests in Petroleum Investments, Ltd. - 1978 (hereinafter referred to as the 1978-Partnership). Although petitioner usually created a limited partnership to finance a single drilling program, three additional drilling programs were financed through additional subscriptions to the 1978-Partnership. The four drilling programs under the 1978-Partnership were designated as follows:

Program	*Date organized*
Petroleum Investments, Ltd. - 1978	Feb. 16, 1978
Petroleum Investments, Ltd. - 1978A	Oct. 28, 1978
Petroleum Investments, Ltd. - 1979	May 21, 1979
Petroleum Investments, Ltd. - 1979A	Oct. 1, 1979

A private placement memorandum was prepared for the initial solicitation of subscriptions to the 1978-Partnership and was supplemented for the subsequent solicitations for subscriptions used to finance the additional drilling programs.

Petitioner was the sole general partner of the 1978-Partnership. The limited partnership agreement of the 1978-Partnership (hereinafter referred to as the 1978-Partnership Agreement) provided that the agreement was to remain in effect for 20 years. The 1978-Partnership Agreement also provided that petitioner, as general partner, was to receive 10 percent of partnership revenue from oil and gas production. The remaining 90 percent of partnership revenue was to be shared among all partners in the ratio that each partner's subscription to the partnership bore to the total subscriptions. Because petitioner subscribed to the partnership individually, he was entitled to share in 90 percent of partnership revenue as a limited partner in addition to his 10-percent share as general partner.

The 1978-Partnership Agreement also provided that, in addition to his broad duties to acquire and oversee the development and operation of oil and gas properties for the drilling programs,[2] petitioner must bear all organization and syndication costs of the partnership. The 1978-Partnership Agreement provided:

> ARTICLE III
>
> *Business of the Partnership and Subscriptions*
>
> * * * * * * *
>
> 3.6 *Plan of Distribution*. Subscriptions and Additional Contributions shall be solicited on a "best efforts" basis by selected broker-dealers for commissions of 3% of amounts secured by them; provided, however, commissions shall be payable only upon amounts actually received by the Partnership at the time of such receipt. The General Partner shall bear all sales commissions. Subscriptions may also be solicited for the Partnership by William Egolf, but no commissions would be payable on sales made by him.
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> * * * * * * *
>
> ARTICLE VI
>
> *Participation in Costs and Revenues*
>
> 6.1 *Costs*. All organizational and offering costs incurred in the offering and sale of Subscriptions and Additional Contributions, including sales commissions, shall be paid 100% by the General Partner. The General Partner shall also be charged with and shall bear 100% of all accounting costs, costs of preparing tax returns for the Partnership and operational overhead costs.

In addition, the offering circulars for the 1978-Partnership explicitly provided that the limited partner subscriptions would not be used for the organization and syndication expenses of the partnership. The offering circulars stated:

> APPLICATION OF PROCEEDS
>
> Limited partner subscriptions will not be used for the payment of costs incurred in organizing the Partnership or selling Units therein, but instead will be used in conducting Partnership operations. * * *

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[2] It was anticipated that third parties would actually operate partnership wells under a contract with the partnership providing for the payment of a monthly per well fee. Petitioner was entitled to act as operator of partnership wells and to that extent was entitled to receive fees as a third party operator.

The 1978-Partnership Agreement summarized the division of costs and revenues between the general partner and limited partners as follows:

	Limited partners	General partner
Costs:		
Offering costs	0%	100%
Accounting costs	0	100
Operational overhead costs[1]	0	100
Management and overall supervision fee	100	0
Acreage costs	100	0
Drilling costs	100	0
Completion costs	100	0
Equipment costs	100	0
Operating costs	90	10
Engineering reserve report	90	0
Revenues:		
Oil and gas production	90	10
Sale of equipment and leases	100	0
Interest earned on partnership funds	0	100

[1] These costs are reimbursed in part by the management and overall supervision fee.

The 1978-Partnership Agreement also provided that petitioner, as general partner, would receive a "Management and Overall Supervision Fee." The Amended 1978-Partnership Agreement described the management and overall supervision fee as follows:

> 4.2 *Compensation.* For his services in managing the Partnership, the General Partner shall be entitled to receive a Management and Overall Supervision Fee equal to 5% of all costs incurred in drilling, completing, testing and equipping Partnership wells, but excluding all costs of acreage acquisition and operating costs.

The 1978-Partnership Agreement does not reveal whether the management fee was to compensate or reimburse petitioner for organization and syndication expenses of the partnership. The private placement memoranda prepared as part of the solicitation of subscriptions to the 1978-Partnership do suggest that the management fee was intended to reimburse petitioner for costs of syndicating the partnership. Under the heading "Compensation" the memoranda described the management fee that the general partner would receive. Also under this same heading is the following:

> Sales commissions up to 3% may be paid to broker-dealers on the sale of interests in the Partnership. Any commissions payable shall be charged to the General Partner, and shall not be recharged to Limited Partners.

During the taxable years 1978 and 1979, petitioner incurred several expenditures in regard to the organization and syndication of the 1978-Partnership including the payments summarized below:

	1978	*1979*
Contractual payments in lieu of commissions	$65,000.00	$50,000.00
General partner's share arrangement	22,685.19	22,933.84
Commissions to brokers/ dealers	[1]178,938.78	475,196.90
Legal and professional services fees	26,690.00	26,560.00

[1] There is also included in the taxable year 1978 amount a payment of $5,745 made with respect to a prior partnership.

The "Legal and professional services fees" represent organization expenses of the 1978-Partnership. The other expenditures represent syndication costs incurred in the solicitation of subscriptions to the 1978-Partnership.

During the taxable years 1978 and 1979, petitioner received payments from the partnership as management fees in the amounts of $925,387.50 and $1,561,237.50. Because of inexact estimates of the costs incurred by the partnership to develop the oil and gas properties, the payments to petitioner throughout the taxable years 1978 and 1979 resulted in overpayments of the management fees in the amounts of $152,937.50 and $343,210.

No formal agreement describing these overpayments as loans, providing a repayment schedule, or establishing a firm due date was executed. Petitioner did not pledge any collateral or otherwise secure the repayment of these amounts to the 1978-Partnership. Nevertheless, petitioner did repay the overpayments with interest in 1982.

Petitioners prepared and appended to the Forms 1040 they filed for the taxable years 1978 and 1979 separate Schedules C, Profit or (Loss) From Business or Profession, reporting the main business activity of "Lease Management." On these Schedules C, petitioners reported the full amount of payments received from the 1978-Partnership, including the overpayments, as "Management Fees." On the same schedules, petitioners claimed deductions for the amounts Egolf expended for organization and syndication expenses of the 1978-Partnership.

On the partnership income tax returns, prepared at the direction of petitioner and on behalf of the 1978-Partnership for the taxable years 1978 and 1979, deductions were claimed for the amount of the management fee paid to which petitioner was entitled under the 1978-Partnership Agreement. The 1978-Partnership did not claim a deduction for the amounts representing overpaid management fees, however, and reported the overpayments as amounts receivable from petitioner. For the taxable years 1978 and 1979, the 1978-Partnership did not separately deduct or capitalize any amounts as organization or syndication costs.

Egolf reviewed and signed petitioners' individual returns and the 1978-Partnership returns for the taxable years 1978 and 1979, despite the disparate treatment of the overpayments of management fees made to petitioner.

In the statutory notice of deficiency issued to petitioners for the taxable years 1978 and 1979, the Commissioner disallowed the deductions claimed for amounts expended by petitioner for organization costs of the 1978-Partnership in the amounts of $26,690 and $26,560, respectively. The Commissioner also disallowed deductions claimed by petitioners representing syndication costs of the 1978-Partnership in the amounts of $266,623.97 for the taxable year 1978 and $548,130.74 for the taxable year 1979.[3]

OPINION

Treatment of Partnership Organization and Syndication Expenses and Management Fees

The payments a partner receives from his ongoing partnership typically fall into one of three categories. A partner may receive payments representing a distribution of partnership income. A partner may also receive payments in his capacity as a partner that do not represent a distribution of partnership income. Sec. 707(c).[4] A partner may also receive payments in circumstances where he is not treated as a partner. Sec. 707(a). The differing nature of these payments has led to confusion over their tax consequences.

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[3] These adjustments in petitioners' taxable income changed the amount of the allowable depletion deduction for the taxable years in issue. The nature and calculation of these adjustments are not in dispute.

In *Cagle v. Commissioner*, 63 T.C. 86 (1974), affd. 539 F.2d 409 (5th Cir. 1976), this Court resolved some of the confusion that existed over the proper tax treatment of these different types of payments. We concluded that payments made to a partner either as guaranteed payments under section 707(c) or made to a partner in his capacity other than as a partner under section 707(a) must satisfy the requirements of section 162(a) before such payments may be currently deducted by the partnership. 63 T.C. at 91. As a result, no deduction is allowed if the payment by the partnership to a partner constitutes a capital expenditure. 63 T.C. at 95. Prior to *Cagle*, partnerships routinely claimed deductions for guaranteed payments made to a partner with the clear understanding that the payments would be used to pay organization and syndication expenses of the partnership, which could not be currently deducted under section 162. While agreeing with *Cagle*, Congress enacted section 709 as part of the Tax Reform Act of 1976, Pub. L. 94-455, sec. 213, 90 Stat. 1547-1549, to eliminate continued confusion surrounding the deductibility of payments made to a partner constituting guaranteed payments under section 707(c). Section 709 explicitly disallows a partnership from currently deducting partnership organization and syndication expenses whether paid directly or indirectly through payments to a partner. S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 131-132; H. Rept. 94-658 (1976), 1976-3 C.B. (Vol. 2) 695, 812-814. Section 709 provides:

> SEC. 709(a). GENERAL RULE.—Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.
>
> (b) AMORTIZATION OF ORGANIZATION FEES.—

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[4] All section references are to the Internal Revenue Code of 1954 as amended and in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

> (1) DEDUCTION.—Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.
>
> (2) ORGANIZATIONAL EXPENSES DEFINED.—The organizational expenses to which paragraph (1) applies, are expenditures which—
>
> (A) are incident to the creation of the partnership;
>
> (B) are chargeable to capital account; and
>
> (C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

The regulations promulgated under section 709 define organization expenses to include: "Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees." Sec. 1.709-2(a), Income Tax Regs.[5] The same regulations define syndication expenses as expenses connected with the issuing and marketing of interests in the partnership. Sec. 1.709-2(b), Income Tax Regs. Syndication expenses are not a category of organization expense. Sec. 1.709-2(a), Income Tax Regs.

The 1978-Partnership Agreement before us was structured in an attempt to avoid the strictures of section 709. Instead of directly bearing nondeductible capital costs of organization and syndication, the 1978-Partnership Agreement required petitioner, as general partner, to bear these costs. The 1978-Partnership reimbursed petitioner for his services to the partnership, including organization and syndication costs, with the management fee, for which it claimed a current deduction. Petitioners then reported the entire amount of the management fee as ordinary income. To complete the circle, petitioners claimed a deduction under section 162 for all of the organization and syndication costs incurred by Egolf on behalf of the 1978-Partnership as an expense of petitioner's trade or business of organizing drilling program limited partnerships.

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[5] Sec. 1.709-1, Income Tax Regs., is generally effective for partnership taxable years beginning after Dec. 31, 1975. Sec. 1.709-1(a), Income Tax Regs.

If we were to respect the form of the above transactions, the 1978-Partnership would have succeeded in currently deducting organization and syndication costs by indirectly paying them to petitioner under the guise of management fees. Further, the transaction would have had no ill effects on petitioners. The management fee income they reported representing reimbursement for the organization and syndication costs of the 1978-Partnership would have been offset by deductions for legal fees and commissions incurred in organizing and syndicating interests in the partnership. Such a result would circumvent the letter and intent of section 709.

In applying section 709 to the instant case, we are constrained to consider the substance of the management fees and not their form. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Brountas v. Commissioner*, 73 T.C. 491, 582 (1979), revd. on other grounds 692 F.2d 152 (lst Cir. 1982), cert. denied 462 U.S. 1106 (1983). To determine whether a portion of the management fees paid to petitioner represent organization or syndication costs of the partnership, "we look to the nature of the services performed [for which the fees were paid] * * * rather than to their designation or treatment by the partnership." *Estate of Boyd v. Commissioner*, 76 T.C. 646, 658 (1981) (quoting *Cagle v. Commissioner, supra* at 96). Our scrutiny of the management fees paid by the partnership to petitioner reveals that they are, in part, reimbursements for organization and syndication costs. Petitioner and his agents repeatedly conceded this much at trial and on brief.

Based upon our conclusion that the management fees represent, in part, reimbursement for partnership organization and syndication expenses, the deduction claimed by the partnership for the taxable years 1978 and 1979 must be reduced by the amount representing organization and syndication fees. Sec. 709(a).[6] The amount of ordinary income reported by petitioners as management fees from the 1978-Partnership for the taxable years in issue must be reduced by a like amount because the management fees, to such extent, were reimbursements, not compensation for services rendered. Accordingly, the deductions claimed as attorney's fees and commissions that represented reimbursements for organization and syndication expenses of the partnership must be disallowed. Because petitioners have failed to prove that the amounts of the adjustments to petitioners' allowable deductions determined by the Commissioner in the notice of deficiency were in error (*Johnsen v. Commissioner*, 83 T.C. 103, 129 (1984); *Flowers v. Commissioner*, 80 T.C. 914, 943 (1983); Rule 142(a)) those amounts will also govern the adjustment to the income of petitioner from management fees and the extent of the management fee deduction the partnership will be allowed.

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[6] We recognize that the correct 1978-Partnership income was not raised as an issue by the parties. Nonetheless, as petitioner's distributive share of partnership income must be considered in our redetermination of petitioners' correct tax liability, the correct partnership taxable income is placed at issue.

The partnership agreement was carefully drafted to disguise the payment of nondeductible organization and syndication costs by the partnership as currently deductible management fees. Viewing the substance of the agreement, we cannot allow the form selected for the transactions between petitioner and the partnership to govern for tax purposes. Moreover, the result we reach is confirmed by an analysis of petitioners' argument that Egolf was acting independently of his capacity as a partner in the 1978-Partnership when he incurred the organization and syndication costs of the partnership.

Petitioners contend that Egolf was in the separate trade or business of organizing and managing drilling program limited partnerships. As such, the management fee he received from the 1978-Partnership represented income from this trade or business. Furthermore, petitioners argue that since Egolf was acting other than in his capacity as a partner under section 707(a) when he incurred the organization and syndication costs, the prohibition of the deduction of such costs in section 709(a) is inapplicable to him. Despite whatever merit this argument may otherwise have, petitioners have failed to meet their burden of proof with respect to a critical element of their argument (*Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a)) that Egolf was not acting in his capacity as a partner of the 1978-Partnership.

Petitioners argue that in receiving the management fees from the partnership and, in turn, paying out commissions on the sale of interests in the partnership and attorney's fees for assistance in organizing the partnership Egolf was acting in a role analogous to an independent broker-dealer. In support of this argument petitioners emphasize that Egolf has performed these services for partnerships formed by him since 1969 and that the payment of these costs was not an isolated occurrence. Although petitioners' argument has some allure when viewed from this perspective, the totality of the facts and circumstances in this case leave us convinced that Egolf was acting as a partner when he incurred the organization and syndication costs on behalf of the partnership. See *Pratt v. Commissioner*, 64 T.C. 203, 212 (1975), affd. in part, revd. and remanded in part 550 F.2d 1023 (5th Cir. 1977).

Petitioner not only received a management fee, but also had a general partnership interest in every drilling program limited partnership he promoted. Furthermore, the obligation to pay the organization and syndication costs of the partnership was not found in a separately executed contract, but rather arose from the partnership agreement. The partnership agreement failed to provide a clear delineation of petitioner's duties as a managing general partner and his alleged role as an independent broker-dealer. Lastly, petitioner was not a licensed broker-dealer during the taxable years in issue. Based upon the facts before us, petitioners' analogy of Egolf's activities to those of an independent broker-dealer is unpersuasive.

It seems clear that the various other duties required of petitioner by the partnership agreement, such as supervising the drilling, completion, and equipping of the wells drilled by the partnership and overseeing their subsequent operation, are so closely associated with the business of the partnership that he was acting as a partner with respect to those activities. *Pratt v. Commissioner*, 64 T.C. at 211.[7]

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[7] However, to the extent, if any, that petitioner acted as the operator of partnership wells, *supra* note 2, we would likely find that he was not acting in his capacity as a partner of the 1978-Partnership. Cf. *Wegener v. Commissioner*, 119 F.2d 49, 51 (5th Cir. 1941), affg. 41

Petitioner was, after all, the sole general partner of a limited partnership. As such, petitioner alone could perform the various managerial functions on behalf of the partnership. Although none of these factors is determinative standing alone, we find that together they confirm our finding that when performing the services for which he received the management fee, including the payment of organization and syndication costs, petitioner was acting in his capacity as a partner. Because the prohibition found in section 709(a) applies both to a partnership and to any partner, the deductions claimed by petitioners which represented organization and syndication of the 1978-Partnership were properly disallowed. Sec. 709(a).

Amortization of Organization and Syndication Expenses

Having concluded that the 1978-Partnership may not currently deduct that portion of the management fees paid to petitioner representing reimbursement for the payment of organization and syndication expenses of the partnership, we must address petitioners' alternative argument that organization and syndication expenses of the partnership may be capitalized and amortized under section 167.

Section 709(a) provides that, except as provided in section 709(b), no deduction is allowed "under this chapter" for partnership organization and syndication expenses.[8] The "chapter" referred to in section 709(a) is "Chapter 1, Normal Taxes and Surtaxes, Subtitle A, Income Taxes," of the Internal Revenue Code of 1954. This chapter encompasses section 167, which allows a deduction for depreciation or amortization of property used in a trade or business or held for the production of income. Therefore, section 709(a) clearly precludes amortization of partnership organization and syndication expenses under section 167. Cf. *Estate of Thomas*, 84 T.C. 412, 440-444 (1985) (amortization of partnership syndication expenses disallowed under law prior to the effective date of section 709). Because petitioners do not contend that an election was properly made by

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B.T.A. 857 (1940), cert. denied 314 U.S. 643 (1941) (decided prior to the enactment of Subchapter K, I.R.C. 1954).

[8] Pursuant to sec. 709(b), organizational, but not syndication, expenses, may, if properly elected, be amortized over a period not less than 60 months.

the partnership, no amortization of partnership organization expenses is allowable under section 709(b).

Management Fee Overpayments as Loans

The last issue before us is whether the 1978-Partnership's management fee overpayments to petitioner are properly characterized as loans or income.

Petitioners claim that management fee overpayments received by Egolf and erroneously reported as income were actually loans to him by the 1978-Partnership. As a result, petitioners seek to exclude from their income for the taxable years 1978 and 1979 the amounts of these overpayments. Respondent maintains that the overpayments were income to Egolf and were properly reported as such by petitioners.

The intention of the parties is the controlling factor in determining whether or not payments are actually considered loans. *Berthold v. Commissioner*, 404 F.2d 119 (6th Cir. 1968), affg. a Memorandum Opinion of this Court; *Miele v. Commissioner*, 56 T.C. 556, 567 (1971), affd. without published opinion 474 F.2d 1338 (3d Cir. 1973), cert. denied 414 U.S. 826 (1973). The intention of the parties relates not so much as to the name or form of the transaction as it does to an actual intent that the advance will be repaid. *Commissioner v. Makransky*, 321 F.2d 598 (3d Cir. 1963). The intention of the parties as to the characterization of the overpayments is a factual question to be decided based upon all the facts and circumstances before us. *Miele v. Commissioner*, 56 T.C. at 567. Petitioners have the burden of proving that the management fee overpayments are actually loans from the 1978-Partnership. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a).

Based upon our consideration of all the facts and circumstances, we conclude that petitioners have failed to carry their burden of proving that the parties intended the overpayments as loans. Important to petitioners' failure to meet their burden of proof was the absence of provisions for adequate security, interest, and repayment of the overpayments. Such objective indicia are persuasive that a loan was intended, although not necessarily compelling. *Berthold v. Commissioner*, 404 F.2d at 122; *Miele v. Commissioner*, 56 T.C. at 568-569; *White v. Commissioner*, 17 T.C. 1562, 1569

(1952). We take note of the fact that there was no provisio in the partnership agreement requiring petitioner to repa excess management fee payments. We also do not find tha the partnership's accounting treatment of the overpayment as amounts receivable from petitioner deserves great weigh in our decision, particularly in light of the inconsisten treatment of these amounts by petitioners on their indivic ual returns. Lastly, the fact that petitioner ultimatel repaid the advances in 1982 is of limited use in determinin what the parties intended when the overpayments occurre

Petititioner, a cash basis taxpayer, received the manag ment fee under a claim of right and was not restricted i the use of the funds and must, therefore, include the entir amount of the payments in taxable income in the year received. *North American Oil Consolidated v. Burnet*, 28 U.S. 417, 424 (1932); *Corliss v. Bowers*, 281 U.S. 376 (1930 Petitioner was given the right to receive management fee under the partnership agreement. That the managemen fees received exceeded the amount to which he was entitle because of an inexact estimation of the correct amount o simply by mistake does not change the result, even if h was under an obligation to repay the overpayments in later taxable period. *United States v. Lewis*, 340 U.S. 590 591 (1951); *Commissioner v. Gaddy*, 344 F.2d 460, 462 (5t Cir. 1965); *United States v. Merrill*, 211 F.2d 297, 303 (9t Cir. 1954).

Our finding that petitioner held the full amount of th management fee, including the overpayments, under a clai of right is confirmed by the actions of petitioner individu ally and on behalf of the partnership. Petitioner, as gener partner, was responsible for maintaining the partnership' books and records. Despite the fact that the overpayment were discovered shortly after the close of the taxable year in issue, the partnership made no effort to induce petitione to repay the overpayments. Petitioner reported the overpay ments as income and had unfettered control over thos amounts for approximately 5 years. In this connection, w point out that petitioners filed an amended joint Feder income tax return for the taxable year 1979 in June 198 long after the discovery of the overpayments and after the repayment. Petitioners did not seek to reduce their taxabl income by the amount of the overpayments on the amended return. On the whole, we are convinced that petitioner treated the overpayments as his rightful property for several years. Petitioner failed to adequately renounce his right to the overpayments in the years received and the amount of the overpayments must be included in petitioners' taxable income. *Commissioner v. Gaddy, supra*; *United States v. Merrill, supra* at 303-304.

Although petitioners must include the overpayments in their taxable income for the taxable years before us, they may be able to deduct the subsequent repayments in the taxable year they are repaid. *United States v. Lewis, supra.* Provided the period of limitations has not expired for the year of repayment, petitioners may be entitled to a refund of tax paid and to utilize section 1341 to obtain the full benefit of the deduction allowed because of the repayment.

Decision will be entered under Rule 155.

CHARLES BAXTER SOUTHERN AND DOROTHY I. SOUTHERN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 15548-84. Filed July 3, 1986.

Ps seek summary judgment and R seeks partial summary judgment. The issue for determination is whether the language of a waiver of the statute of limitations encompasses an increase in the tax under sec. 47, I.R.C. 1954. Ps waived the statutory period of limitation for any adjustment to P husband's share of any item of credit of a partnership in which P husband was a partner. The language of the waiver is identical, in part, to sec. 702(a)(7). *Held*, the language of the waiver and sec. 702(a)(7) encompasses the investment credit authorized by sec. 38. *Held, further*, an adjustment to a credit includes a recomputation under sec. 47. *Held, further*, R has made the requisite showing that there is no genuine issue of material fact as to the efficacy of the waiver, and R's motion for partial summary judgment is granted.

William J. Falk, for the petitioners.
Ronald J. Long, for the respondent.

OPINION

HAMBLEN, *Judge*: This case is before the Court on petitioners' motion for summary judgement filed on April 15, 1985, pursuant to Rule 121,[1] and respondent's motion for partial summary judgment, filed on April 23, 1985, pursuant to Rule 121. In their respective motions, each party claims that summary disposition is appropriate on the issue of the efficacy of a Form 872-A, Special Consent to Extend the Time to Assess Tax.

Respondent issued a notice of deficiency to petitioners on February 23, 1984. In this notice, respondent determined a deficiency in petitioners' joint Federal income tax for the taxable year ending December 31, 1978, in the amount of $101,883. The deficiency was attributable to an increase in the tax pursuant to section 47, relating to the disposition or cessation of use of property for which a credit under section 38 was allowed. This adjustment pertained to petitioner Charles Baxter Southern's interest in Memphis Barge Co., a partnership. Petitioners' joint Federal income tax return for 1978 was filed or deemed filed on April 15, 1979.

Petitioners resided in Caruthersville, Missouri, when they filed their petition in this case. In their original petition filed on May 25, 1984, petitioners claimed that respondent erred with respect to the substantive basis for imposition of an increase in the tax under section 47. In their amended petition filed on May 27, 1985, petitioners also claimed that the notice of deficiency was not timely pursuant to sections 6213(a) and 6501. Respondent filed answers to both petitions. In his answer to the amended petition, respondent made affirmative allegations to which petitioners filed a reply. The case was at issue on April 8, 1985, when petitioners' reply was filed. Rule 38.

The parties agree that petitioners executed two extensions of time to assess the tax pursuant to section 6501(c)(4). The second extension, a Form 872-A, Special

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the years at issue.

Although characterized as a motion for judgment on the pleadings pursuant to Rule 120, we have considered matters outside of the pleadings. Consequently, petitioners' motion will be disposed of as a motion for summary judgment pursuant to Rule 121. Rule 120(b).

Consent to Extend the Time to Assess Tax, provided, in part:

> The amount of any deficiency assessment is to be limited to that resulting from *any adjustment to: (a) the taxpayer's distributive share of any item of income, gain, loss, deduction, or credit of, or distribution from Memphis Barge Co.*; (b) the tax basis of the taxpayer's interest in the aforementioned partnership or organization treated by the taxpayers as a partnership; and (c) any gain or loss (or the character or timing thereof) realized upon the sale or exchange, abandonment, or other disposition of taxpayer's interest in such partnership or organization treated by the taxpayers as a partnership; including any consequential changes to other items based on such adjustment. [Emphasis added].

The language in petitioners' consent is based on the language set forth in the Internal Revenue Service Manual, I.R.M. sec. 4541.72(4)(d)3. Respondent prepared the consent language. The Form 872-A was executed by both parties in August of 1982.

On July 22, 1982, petitioners were informed by letter that their examination for the taxable year ending December 31, 1978, had been completed and that they had 30 days in which to contact the Internal Revenue Service to request a conference with the Office of the Regional Director of Appeals. Enclosed with the letter was a copy of Form 886-A, Explanation of Items. The two items shown as unagreed adjustments on this form were an increase in taxable income attributable to Memphis Barge Co. in the amount of $1,289,998 and "Investment Tax Credit Recapture" in the amount of $101,883.

Petitioners submitted a formal protest with respect to respondent's examination results on October 29, 1982. The exceptions stated in the protest related to the increase in taxable income attributable to Memphis Barge Co. and "the proposed recapture of investment tax credit in the amount of $101,883 for the taxable year 1978." Between the date petitioners' protest was submitted and the date of the issuance of the notice of deficiency, petitioners' representatives attended conferences with one of respondent's appeals officers in which the investment credit issue was discussed.

A decision will be rendered on a motion for summary judgment if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decisio may be rendered as a matter of law. Rule 121(b). Th burden of proving that there is no genuine issue of materi fact is on the moving party. *Adickes v. Kress & Co.*, 39 U.S. 144, 157 (1970);[2] *Graf v. Commissioner*, 80 T.C. 94 946 (1983); *Espinoza v. Commissioner*, 78 T.C. 412, 41 (1982). The opposing party is to be afforded the benefit o all reasonable doubt, and any inference to be drawn fro the underlying facts contained in the record must be viewe in a light most favorable to the party opposing the motio for summary judgment. *Espinoza v. Commissioner*, *supra* a 416. Where both parties submit motions for summar judgment, each motion must be examined to determine i the moving party has established that there is no genuin issue as to any material fact and that a decision may b rendered as a matter of law. *Take v. Commissioner*, 82 T.C 630, 633 (1984).

Here, petitioners maintain that the items mentioned i the Form 872-A, Special Consent to Extend the Time t Assess Tax, do not include an increase in tax pursuant t section 47. Consequently, they argue that the notice o deficiency issued on February 23, 1984, in which the so unagreed change was an increase in tax pursuant to sectio 47, was not timely. Respondent maintains that the languag of the consent clearly and unambiguously encompasses a increase in tax pursuant to section 47. In the alternativ respondent maintains that if the language of the consen does not encompass an increase in tax pursuant to sectio 47, the parties' actual intent to extend the statute o limitations for the item should be given effect in light of latent ambiguity in the language and, in any event, claim that petitioners are estopped from denying the efficacy o the consent. Consequently, respondent argues that th notice of deficency was timely.

The threshold question here is whether the language o the consent is broad enough to encompass an increase i tax pursuant to section 47. The consent language do include a deficiency assessment resulting from an adjus ment to petitioners' distributive share of any item of credit of Memphis Barge Co. Petitioners argue that the investment credit is not a distributive partnership item and therefore cannot come within the language of the consent. Petitioners also argue that an adjustment does not include an increase in tax pursuant to section 47. For the reasons discussed below, we cannot agree with petitioners' contentions.

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[2] Summary judgment under Rule 121 is derived from rule 56, Fed. R. Civ. P. Hence in a question turning on the interpretation of Rule 121, the history of rule 56, Fed. R. Civ. P., a the authorities interpreting such rule are considered by the Tax Court. See *Hoeme* *Commissioner*, 63 T.C. 18, 21 (1974); *Shiosaki v. Commissioner*, 61 T.C. 861, 862 (1974).

The language of the consent and the language of I.R.M. sec. 4541.72(4)(d)3 follow the language of section 702(a) which provides, in pertinent part:

> SEC. 702(a). GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—
>
> * * * * * * *
>
> (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, * * *

Section 702(a)(7), formerly section 702(a)(8), was intended to be a "catch-all" provision which would permit the Secretary to prescribe regulations which would require each partner to separately account for items of income, gain, loss, deduction, or credit not otherwise enumerated, the character of which would affect the computation of the partner's personal income tax. S. Rept. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. 377 (1954); H. Rept. 1337, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. A222 (1954).

The Secretary has prescribed regulations pursuant to his authority granted in section 702(a)(7). Sec. 1.702-1(a)(8), Income Tax Regs. These regulations do not specifically enumerate the investment credit authorized by section 38. Sec. 1.702-1(a)(8)(i), Income Tax Regs. The regulations, however, do provide that, in addition to the enumerated items, the following shall be separately stated under section 702(a)(7):

> his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. * * * [Sec. 1.702-1(a)(8)(ii), Income Tax Regs.]

The language of the regulation and the correspondin legislative history relating to section 702(a)(7) does encompass an investment credit under section 38 when a partnership acquires qualified property.[3] This interpretation i consistent with the legislative history of section 702(a)(7 which defines the purpose of this statutory provision as "catch-all" for partnership items not otherwise enumerated.

The amounts computed under section 38 are distributabl partnership items. While the investment credit provision do not refer to partnerships, in the context of sectio 48(c)(1), relating to the purchase of used section 38 property, we have recognized that an entity rather than a aggregate approach should be used in determining whethe the property was used by the same person who used th property prior to purchase. *Moradian v. Commissioner*, 5 T.C. 207, 211-212 (1969).[4] Although the operative term used when determining the amount of investment credit i "taxpayer" and not "person" (see, e.g., sec. 46(c)(1)), it i clear that an entity rather than an aggregate approach i contemplated. As in *Moradian*, the operative term include a partnership. Sec. 7701(a)(14).[5] It is the partnership which places the property in service under section 46(c)(1). Therefore, the focus of the investment credit provisions i initially on the partnership as an entity, and the investment credit is a partnership item for which each partner mus report a distributable share.[6]

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[3] Although not specifically enumerated in the regulations, it is clear that the Secretar interprets the language of sec. 1.702-1(a)(8)(ii), Income Tax Regs., as including this item. Th 1978 Form 1065, U.S. Partnership Return of Income, Schedule K, Partners' Shares of Incom Credits, Deductions, Etc., Line 19, provides for a computation of investment credit. Th corresponding Schedule K-1, Partner's Share of Income, Credits, Deductions, Etc., reflects th investment credit property on Line 19. See also 1 A. Willis, J. Pennell & P. Postlewait Partnership Taxation, sec. 71.08, at 71-12 (3d ed. 1981); 1 W. McKee, W. Nelson & Whitmire, Federal Taxation of Partnerships and Partners, sec. 9.03[2], at 9-15 (1977).

The investment credit provisions enacted by the Revenue Act of 1962, Pub. L. 87-834, Stat. 960, postdate sec. 702 enacted by Pub. L. 591 (1954).

[4] See also *Kipperman v. Commissioner*, T.C. Memo. 1977-32, affd. 622 F.2d 431 (9th C 1980); *Holloman v. Commissioner*, T.C. Memo. 1975-309, affd. 551 F.2d 987 (5th Cir. 1977).

[5] Sec. 7701(a)(14) provides that a "taxpayer" is any person subject to any internal reven tax. Sec. 701 specifically exempts a partnership from income tax liability but does not exem a partnership from other taxes imposed by the Internal Revenue Code. Thus, a partnership i a taxpayer for purposes of sec. 7701(a)(14). See 1 A. Willis, J. Pennell & P. Postlewait Partnership Taxation, sec. 72.01, at 72-3 (3d ed. 1981).

[6] Our analysis is consistent with sec. 1.46-3(f), Income Tax Regs., which refers to "partnership section 38 property."

The investment credit authorized by section 38 must be "separately taken into account." The partnership, itself, is not subject to the income tax. Sec. 701. Without a separate statement of this item there would be no income tax effect for the partners. Consequently, failure to reflect this partnerhsip item separately would result in a different income tax liability for the partners.

The language of the consent is identical, in part, to the language of section 702(a)(7). Having determined that the language of section 702(a)(7) is applicable to the investment credit under section 38, we necessarily find that the language of the consent also encompasses the investment credit.

The language of section 702(a)(7) does not encompass a recomputation of the investment credit under section 47. However, the consent adds the word "adjustment" to the language of section 702(a)(7).[7] "Adjustment" is not a defined term in the Internal Revenue Code. In common usage, "adjustment" is defined, in part, as an "increase or decrease." Webster's Third New International Dictionary (1971). A "recapture" recomputation of the investment credit pursuant to section 47 is clearly a decrease in or adjustment to the credit. In fact, the committee reports to section 47, as originally enacted, refer to this recomputation as a "special adjustment." S. Rept. 1881, 87th Cong. 2d Sess. (1962), 1962-3 C.B. 703, 724; Conf. Rept. 2518, 87th Cong. 2d Sess. (1962), 1962-3 C.B. 402, 417. The consent contains no limitation as to the year for which the credit being adjusted was claimed. Consequently, any adjustment to petitioners' distributable share of partnership credits reflected on petitioners' 1978 Federal income tax return, irrespective of the year in which the credit was originally claimed, would be encompassed by the language of the consent.

It is clear from this record that there is no genuine issue of material fact as to the efficacy of the consent. Both parties were aware that an increase in tax pursuant to section 47 relating to Memphis Barge Co. was an issue at

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[7] The Secretary required partnership reporting of recapture amounts on the 1978 Form 1065, U.S. Partnership Return, Schedule K-1, Partner's Share of Income, Credits, Deductions, Etc., Line 20.

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the administrative level and executed a consent which validly extended the statute of limitations for this item. Having made this determination, we decline to consider respondent's alternative arguments.

In conclusion, we note that petitioners' contention is inconsistent with the concept of Subchapter K of the Internal Revenue Code that the partnership is not a taxable entity for Federal income tax purposes, and partners bear the benefits and burden of income, allowances, and credits unless otherwise specifically provided. Petitioners' argument convolutes the purpose of the income tax partnership provisions which generally pass to the partners their respective distributive shares of income, gain, loss, deductions, and credits attributable to the partnership. Adjustment by respondent of any such partnership item consequently must require a correlative "adjustment" of a partner's distributive share of that item. Petitioners' contention would cunningly alter that concept and, consequently, must be rejected.

To reflect the foregoing,

An appropriate order will be issued.

JAMES B. LEAHY AND KATHLEEN S. LEAHY, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 9475-84, 9488-84. Filed July 3, 1986.

P is claiming depreciation and investment tax credit in connection with a movie through his interest as a limited partner. P contends that the partnership purchased the ownership interest in a motion picture photoplay and R argues that the partnership did not have any ownership interest which would enable limited partners to receive tax benefits. In a fully stipulated case where the parties agreed upon the facts and issues to be presented, R raised a new position or issue for the first time in his opening brief. *Held,* the partnership did not acquire a 100-percent ownership interest in the movie, but did become a joint venturer with the producer, and the partnership held a 25-percent interest in the movie for purposes of depreciation, investment tax credit, etc. *Held, further,* R's attempt to raise a new position

or issue was untimely under the circumstances and prejudical to P.

Lawrence A. Chez, Matthias A. Lydon and *Roman L. Sukley*, for the petitioners.

Lauren W. Gore, for the respondent.

GERBER, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes for the taxable years 1978 and 1980 of $177,974 and $36,564, respectively. Respondent also determined additions to tax under section 6653(a)[1] for the taxable years 1978 and 1980 in the amounts of $11,736 and $6,906, respectively. With respect to the taxable year 1980, respondent determined an addition to tax under section 6651(a) in the amount of $5,469. The parties have filed a stipulation of settled issues which purports to resolve all but one adjustment common to both the 1978 and 1980 taxable years in these consolidated cases.[2] The issue remaining in controversy is whether a limited partner is entitled to claim a proportionate share of the partnership's claimed depreciation and investment tax credit in connection with a movie entitled "Overboard."

FINDINGS OF FACT

This case was submitted fully stipulated and the stipulation of facts and exhibits are incorporated by this reference. Petitioners James and Kathleen Leahy maintained their legal residence in Palos Heights, Illinois, at the time of filing both petitions in these consolidated cases. Petitioners filed their joint U.S. Individual Income Tax Return (Form 1040) for the taxable years 1978 and 1980 with the Internal Revenue Service Center at Kansas City, Missouri. The Service Center received the 1978 return on June 2, 1980, and the 1980 return on November 4, 1981. Notices of deficiency, dated January 11 and January 24, 1984, were issued to petitioners concerning their income tax liabilit for petitioners' 1978 and 1980 taxable years, respectively

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[1] All statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in question, and all Rule references are to the Rules of Practice and Procedure of this Court.

[2] The parties have agreed that petitioners are not liable for the addition to tax under sec. 6653(a) for the taxable years 1978 and 1980. The parties, however, have not stipulated with respect to the addition to tax for the 1980 taxable year under sec. 6651(a).

The remaining issue presented for our consideratio concerns James B. Leahy's (petitioner's) involvement as limited partner in Lorelei Productions, Ltd. (Lorelei), a Illinois limited partnership organized May 31, 1978. Lorel was organized "to acquire, own, license, distribute, sell an otherwise exploit motion pictures, television productio and other entertainment products."

Lorelei had one general partner, Homer J. Askounis, wh contributed $100 of capital to the partnership. Petitione was one of six limited partners who collectively contribute $195,000 of capital to Lorelei. Other than the $195,000 an $100 referenced above, neither the general partner nor th limited partners were required to make additional capita contributions. Petitioner's contribution to Lorelei was com posed of a cash payment of $12,870 on August 11, 1978 and two irrevocable letters of credit, each in the amount o $7,500, which were due on June 30, 1979, and June 30 1980, respectively. On or about May 31, 1978, Lorel entered into a Motion Picture Purchase Agreement with Factor Newland Production Corp. (Factor), which recited that Lorelei was to acquire the motion picture photoplay "Overboard," including the negative and color reversal internegative. Legal title and copyright to the photoplay was to be held by and registered in Factor's name until assignment was requested by Lorelei, but the assignment could not be requested until after the domestic broadcast o the movie "Overboard." The agreement indicated that Factor held the copyright in trust for Lorelei. The agre ment granted to Lorelei, among other rights, the right to al benefits of the agreements which had already been made with National Broadcasting Co.(NBC) and Time-Life Films, Inc. (Time-Life).

Factor was incorporated in California on December 22, 1976. In October 1977, Factor obtained the photoplay rights to the novel *Overboard*, written by Hank Searls. About a month later, Factor entered into an agreement with NBC granting NBC exclusive right to broadcast an initial run and one rerun (within 3 years) of the delivery of the movie "Overboard." Delivery was to occur on or before August 15,

1978. In exchange, NBC was to pay Factor $1,190,000, consisting of a $975,000 flat fee and $215,000 representing reimbursement for fees paid to movie stars Angie Dickinson and Cliff Robertson. The $1,190,000 was to be paid in installments with an agreed amount advanced at the time the program was ordered and one-third of the balance advanced at the time of the commencement of photography, completion of photography, and 10 days after delivery of the program to NBC.

On or about June 13, 1978, Factor entered into a distribution agreement with Time-Life wherein Time-Life was granted the distribution rights to the movie for a term of 20 years, essentially from the date the NBC license expired. In exchange, Time-Life agreed to pay Factor a $300,000 advance against Factor's share of the gross receipts, payable $125,000 upon delivery of the movie to Time-Life, $58,334 when the NBC license expired, and $58,333 both 1 year after and 2 years after the NBC license ended. The Time-Life agreement required the following distribution of gross receipts. First, Time-Life was to retain its distribution charges and expenses, thereafter Time-Life was entitled to recoup all advances paid to Factor and any remaining balance of gross receipts was to be paid to Factor. At the end of the 20-year period, Time-Life had an option to renew for an additional 20 years by means of written notice to Factor. If renewed, the earliest date on which the distribution agreement would expire is the year 2019.

Pursuant to the May 31, 1978, agreement, Lorelei was to pay Factor $2,390,000 for the movie "Overboard." The $2,390,000 was to be payable as follows:

$50,000	On execution of agreement
1,315,000	On delivery of film to NBC
50,000	One year from date of agreement
50,000	Two years from date of agreement
87,500	One year after date of delivery to NBC
87,500	Two years after date of delivery to NBC
150,000	Payable only out of 75 percent of net proceeds
200,000	Payable only out of 75 percent of net proceeds
400,000	Payable only out of 75 percent of net proceeds
2,390,000	

Any "net profits" after payment of the $2,390,000 were to be divided 25 percent for Lorelei and 75 percent for Factor.[3]

On or about July 9, 1979, Lorelei and Factor executed an amendment which changed the payment schedule in the following manner. Instead of $1,315,000 being payable at the time of delivery of the film to NBC, only $1,190,000 was payable upon such event and the remaining $125,000 was not payable until delivery of the film to Time-Life. The other change to the payment schedule added a $58,334 payment when the NBC license period was to expire and reduced the $87,500 payments made 1 year and 2 years after delivery to NBC to $58,333 each. None of these changes would have affected the total amount due under the agreement; only the amount and timing of payments were varied slightly.

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[3] "Net profits" are defined in the "May 1978 Lorelei agreement," as follows:

3(b) * * *

(i) From the total revenues (hereinafter referred to as "net revenues") paid by Time-Life * * *, [Factor] shall first recoup any liability for residuals payments which [Factor] incurs for network runs of the Photoplay beyond the first two network runs to the extent that [Factor's] total liability for residuals payments is increased as a result of subsequent runs of the Photoplay after the first two network runs being network runs rather than syndication runs. There shall then be deducted the next $75,000.00 received, which sum shall be retained by [Lorelei].

(ii) The balance of net revenues paid by Time-Life after [Factor] has recouped any additional residuals liabilities for subsequent network runs after the first two network runs and [Lorelei] has retained $75,000.00 shall be deemed "net proceeds".

(iii) [Factor] shall receive the first $59,500.00 of net proceeds, which sum [Factor] shall pay to the William Morris Agency.

(iv) The next $100,000.00 of net proceeds shall be divided as follows: [Lorelei] shall receive forty percent (40%) and [Factor] shall receive sixty percent (60%).

(v) All further net proceeds shall be divided as follows: [Lorelei] shall receive twenty-five percent (25%) and [Factor] shall receive seventy-five percent (75%).

(vi) The next $150,000.00 of net proceeds which [Factor] receives shall be payment of the sum due to [Factor] under Paragraph 3(a)(vii).

(vii) The next $200,000.00 of net proceeds which [Factor] receives shall be payment of the sum due [Factor] under Paragraph 3(a)(viii).

(viii) The next $400,000.00 of net proceeds which [Factor] receives shall be payment of the sum due [Factor] under Paragraph 3(a)(ix).

(4) DIVISION OF NET PROFITS:

(a) After [Factor] and [Lorelei] have receive [sic] all net proceeds due them under Paragraph 3(b), all further net revenues paid by Time-Life shall be deemed "net profits." All net profits shall be divided between [Lorelei] and [Factor] as follows: [Lorelei] shall receive twenty-five percent (25%) of all net profits and [Factor] shall receive seventy-five percent (75%) of all net profits.

* * * * * * *

(c) [Factor] shall be entitled to seventy-five percent (75%) and [Lorelei] shall be entitled to twenty-five percent (25%) of all foreign tax credits due in connection with the proceeds derived from the Photoplay outside the United States.

Factor delivered the film to NBC about August 7, 1978, and the first network broadcast occurred September 25, 1978. NBC aired the film a second time on September 3, 1979.

Under the motion picture purchase agreement, Lorelei could not enter into any distribution agreements without the consultation and approval of Factor. Lorelei was not a party to either the NBC license agreement dated November 21, 1977, or the Time-Life agreement dated June 13, 1978. Further, Lorelei did not directly pay any portion of the production costs of the movie. The actual production costs were incurred by Factor in the amount of $1,487,445. All payments made by NBC and Time-Life under the respective agreements were either made directly to Factor or to Factor through the William Morris Agency.

Lorelei was organized with six limited partners, one of whom was petitioner, and one general partner named Homer J. Askounis. Unlike the six limited partners whose capital contributions ranged between $19,500 and $43,875 (for a total capital contribution of limited partners in the amount of $195,000), Mr. Askounis made a capital contribution of only $100. Even though designated as a general partner, Mr. Askounis did not play a role in the negotiation of the motion picture purchase agreement between Lorelei and Factor, and his involvement with Lorelei was limited to the execution of documents, including the partnership returns of Lorelei, as general partner.

Lorelei's checking account was opened on August 4, 1978, with an attorney, Robert Greenberg (who was not a partner), and Edward B. Chez (who was not a partner and was one of the accountants to Lorelei) as signatories. Attorney Greenberg, in 1978, had contacted Mr. Askounis to serve as Lorelei's general partner. Further, attorney Greenberg made three contacts during 1978 resulting in the purchase of three interests as limited partners in Lorelei. Accountant Chez contacted petitioner and two other limited partners. Accordingly, although attorney Greenberg and accountant Chez did not become active participants in Lorelei, they were the "promoters."

NBC made payments to Factor, through the William Morris Agency, as follows:

Date	*Amount*	*Purpose*
Nov. 16, 1977	$25,000.00	Film rights costs
Jan. 5, 1978	17,599.90	Script draft
Feb. 28, 1978	11,841.00	Final script
Feb. 15, 1978	100,000.00	Pre-production advance
Mar. 15, 1978	363,333.34	Commencement of principal photography
Mar. 31, 1978	33,333.33	Balance of principal photography
Apr. 14, 1978	330,000.00	Completion of principal photography
Aug. 7, 1978	308,892.43	Film delivery
Total	[4]1,190,000.00	

On its returns (Forms 1065) for the taxable years 1978, 1979, and 1980, Lorelei reported the following amounts of gross receipts from the sources indicated:

1978:	NBC license fee	$1,190,000
	Time-Life fee	125,000
		1,315,000
1979:	Time-Life fee	87,500
1980:	Time-Life fee	87,500

Partnership returns of income were filed for Lorelei's 1978, 1979, and 1980 taxable years under the cash method of accounting reflecting the following amounts of gross receipts, depreciation, ordinary income or loss and the basis of property for which investment tax credit was being claimed:

Taxable year	*Gross receipts*	*Total depreciation claimed*	*Ordinary income (or loss)*	*Basis of property claimed as qualifying for investment tax credit*
1978	$1,315,000	$1,287,766	$12,170	$1,348,844
1979	87,500	85,688	(7,624)	44,395
1980	87,500	85,688	469	---

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[4] Respondent's brief reflected total payments from NBC of $1,190,000.93, but the sum of the numbers presented was only $1,189,999.43. The exhibits stipulated by the parties varied from respondent's brief, which was not objected to by petitioners on this point, as follows: (1) Jan. 5, 1978, check was $17,599.00 and should have been $17,599.90; (2) Aug. 7, 1978, check was $308,892.76 and should have been$308,892.43. After substituting the correct amounts, the sum total becomes $1,190,000.00, the same amount reflected on the Forms 1065 by Lorelei.

Petitioner, in connection with his investment in Lorelei, of 12,870 in cash and $15,000 in irrevocable letters of credit for a total of $27,870 which represented a 14.85-percent nterest in Lorelei), reported the following income (loss) and nvestment tax credits for the taxable years 1978, 1979, and 1980:

Taxable year	*Income or (loss)*	*Investment tax credit*
1978	$1,807	$20,028
1979	[5](1,132)	[6]659
1980	70	. . .

OPINION

The sole question remaining for our consideration is respondent's disallowance of depreciation and investment tax credit in connection with petitioner's investment, as one of six limited partners, in a partnership (Lorelei). Lorelei was organized to exploit motion pictures. Lorelei entered into an agreement with Factor, a motion picture producer, to exploit the movie "Overboard." In the statutory notices,[7] respondent provided the following reasons for disallowance: (1) Lack of "actual" ownership interest in the movie; (2) loans are too contingent and lack economic substance to be considered part of the depreciable basis in the movie; (3) the fair market value of the movie has not been established in an amount which would support the amount of the "loans" for purposes of limited partner's basis; (4) "the partnership's method of depreciation does not bear a proper relationship to the decline in the usefulness of the movie"; and (5) claimed amortization is not allowable because (a) amount used as basis was not paid, or if paid not amortizable, and (b) the obligation underlying the claimed amortizable asset was either not petitioners' or was subject to a contingency.

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[5] This figure was extrapolated from Schedule K-1 for petitioner and part of Lorelei's 1979 Form 1065 which reflects $6,593 in property subject to investment tax credit.

[6] This figure was taken directly from Schedule K-1 for petitioner.

[7] One statutory notice, issued Jan. 24, 1984, concerned petitioners' 1978 taxable year. The other notice, issued Jan. 11, 1984, concerned petitioners' 1980 taxable year. The 1980 notice contained explanatory paragraphs concerning the Lorelei disallowances, whereas the 1978 notice designated the specific amounts of disallowance, without express explanatory paragraphs.

On brief, respondent advanced the additional ground that neither Lorelei nor petitioners attached the statement required by section 1.48-8(g)(3), Income Tax Regs., as a prerequisite to enablement to claim the investment tax credit for a movie purchased after January 19, 1978.[8] Respondent, also on brief, abandoned reliance upon the fair market value, economic substance, contingency of indebtedness or income stream, and method of depreciation bases for disallowance. Respondent's remaining positions for disallowance of depreciation, amortization, and investment tax credit are failure to comply with requirements of section 1.48-8(g)(3), Income Tax Regs., and that the partnership did not acquire an ownership interest in the movie which would entitle its partners to claim depreciation or investment tax credit.

Timeliness of Respondent's Sec. 1.48-8(g)(3), Income Tax Regs., Position

This Court has on numerous occasions addressed the timeliness of a party's attempt to raise a new position.[9] It is within our discretion to permit a new issue or ground if we find that the opposing party is not prejudiced by such permission. *Commissioner v. Erie Forge Co.*, 167 F.2d 71, 74-75 (3d Cir. 1948), affg. a Memorandum Opinion of this Court; *Law v. Commissioner*, 84 T.C. 985, 992 (1985); *Estate of Horvath v. Commissioner*, 59 T.C. 551, 555-556 (1973).

Of key importance in evaluating the existence of prejudice is the amount of surprise and the need for additional evidence on behalf of the party in opposition to the new position. To be sure, petitioners were surprised to learn of respondent's "regulation position" on brief, due to its absence from the statutory notices and the pleadings. In this case, the parties submitted the case with the facts fully stipulated and presumably with an understanding of the legal issues to be presented and defended. Respondent raised numerous grounds for disallowance by statutory notice, which would have come within the presumption of correctness afforded respondent, *Welch v. Helvering*, 290 U.S. 111, 115 (1933), and respondent had several other opportunities to raise new issues or grounds. *Seligman v. Commissioner*, 84 T.C. 191, 198 (1985).[10]

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[8] Our ultimate finding that Lorelei did not purchase the movie, but instead joined the producer in a joint venture, would appear to obviate the need to comply with sec. 1.48-8(g)(3), Income Tax Regs., because there was no purchase of the qualified film "by taxpayer other than original owner."

[9] There is no need to consider whether respondent's position is merely a new theory which clarifies or develops respondent's original determination (*Estate of Scharf v. Commissioner*, 38 T.C. 15, 27-28 (1962), affd. 316 F.2d 625 (7th Cir. 1963)), or a new matter, for which respondent would bear the burden of proof (*Achiro v. Commissioner*, 77 T.C. 880, 890 (1981)), because of our ultimate conclusion regarding respondent's timeliness in raising this position.

Respondent's new position is that Lorelei's and petitioners' failure to comply with section 1.48-8(g)(3), Income Tax Regs., by not attaching a statement to returns which are the subject of this case would prohibit petitioners from claiming the investment tax credit with respect to the movie. Respondent raises this ground after raising more than five in the statutory notice and refining the major thrust, on brief, to one of the original grounds and the proposed new ground. The longer respondent delays in disclosing theories, "the more reason there is to conclude that the taxpayer has not received fair notice and has been * * * prejudiced." *Commissioner v. Transport Mfg. & Equip. Co.*, 478 F.2d 731, 736 (8th Cir. 1973). This is especially true here, where there was no trial and the facts were fixed by agreement. Compare *Stewart v. Commissioner*, 714 F.2d 977 (9th Cir. 1983), affg. a Memorandum Opinion of this Court. Accordingly, we hold that petitioners were surprised by the new ground and their ability to present their case was prejudiced. *Seligman v. Commissioner, supra*; *Estate of Horvath v. Commissioner, supra* at 556; *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601, 617 (1964).

Entitlement to Depreciation and Investment Tax Credit

We are convinced that the movie "Overboard" is an asset for which depreciation and investment tax credit may be available to its owner. Indeed, "Overboard" was a successful movie which had been licensed to NBC and Time-Life Films for more than a 20-year period in exchange for fixed periodic payments that would total $1,490,000. The $1,490,000 were minimum payments and additional royalties or license fees would be paid to the extent that Time-Lif recouped its distribution charges, expenses, and th $300,000 advanced for the license. The only question we ar asked to decide is whether petitioner, through his limite partnership interest in Lorelei, was an "owner" of the movi "Overboard" so as to be entitled to claim both depreciatio and investment tax credit in connection with the investment.

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[10] It seems ironic that respondent seeks to defeat petitioner for failure to comply with the procedural portion of a regulation which respondent failed to raise during the audit, issuance of the notice of deficiency, filing of an answer or submission of the case for our consideration.

Respondent does not question the value or bona fides o the subject matter, but only whether Lorelei acquired a ownership interest. Although respondent has broken th question of entitlement to depreciation and investment ta credit into two separate arguments, we find it mor convenient to discuss them together. Accordingly, we shal analyze to what extent, if any, ownership of the movi transferred from the producer, Factor, to Lorelei.

Petitioner asserts that the transfer was achieved by means of a sale. A sale is a transfer of property for money or a promise of payment. *Commissioner v. Brown*, 380 U.S 563, 570-571 (1965). For purposes of Federal taxation, a sal occurs upon the transfer of the benefits and burdens o ownership, rather than upon the satisfaction of the technica requirements for the passage of title under State law. *Houchins v. Commissioner*, 79 T.C. 570, 590 (1982); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981).

The consideration of whether the benefits and burdens have been transferred is essentially a factual determination and as outlined in *Houchins v. Commissioner*, *supra* at 591,

> is to be ascertained from the intention of the parties as evidenced by th written agreements read in light of the attendant facts and circumstances. *Grodt & McKay Realty, Inc. v. Commissioner*, *supra*. Among th factors to be considered in making this determination are: (1) Whethe legal title passes; (2) the manner in which the parties treat th transaction; (3) whether the purchaser acquired any equity in th property; (4) whether the purchaser has any control over the property and, if so, the extent of such control; (5) whether the purchaser bears th risk of loss or damage to the property; and (6) whether the purchaser wil receive any benefit from the operation or disposition of the property. Se *Grodt & McKay Realty, Inc. v. Commissioner*, *supra* at 1237-1238. * * * [Fn. ref. omitted.]

The passage of title to a motion picture is accomplished through the transfer of both the negative and copyright. The basic principles to be considered were outlined and set forth in *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1041-1043 (1986), as follows:

> Ownership of a motion picture negative is distinct from ownership of the copyright thereto (17 U.S.C. sec. 202 (1982) (effective Jan. 1, 1978); *Michael Todd Co. v. Los Angeles County*, 57 Cal. 2d 684, 371 P.2d 340, 21 Cal. Rptr. 604 (1962), and cases cited therein), and ownership of the former without possession of at least certain of the rights encompassed by the latter is commercially valueless. See *Misbourne Pictures Ltd. v. Johnson*, 189 F.2d 774, 776 (2d Cir. 1951). Copyrights are monopolies; "they entitle the owner to prohibit various kinds of reproduction, and to relieve individuals of these prohibitions by licenses." *Goldsmith v. Commissioner*, 143 F.2d 466, 467 (2d Cir. 1944) (L. Hand, J., concurring), affg. on other grounds 1 T.C. 711 (1943). The exclusive rights that comprise the so-called "bundle of rights" that is a copyright in a motion picture are detailed in 17 U.S.C. sec. 106 (1982):
>
> Subject to sections 107 through 118, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following:
>
> (1) to reproduce the copyrighted work in copies or phonorecords;
>
> (2) to prepare derivative works based upon the copyrighted work;
>
> (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
>
> (4) in the case of * * * motion pictures and other audiovisual works, to perform the copyrighted work publicly; and
>
> (5) in the case of * * * the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.
>
> Each of the five rights comprising the copyright may be subdivided indefinitely, and under copyright law, each subdivision of an exclusive right may be owned and enforced separately. 17 U.S.C. sec. 201(d) (1982).
>
> For tax purposes, a sale of a motion picture occurs when there is a transfer of all substantial rights of value in the motion picture copyright. *Carnegie Productions, Inc. v. Commissioner*, 59 T.C. 642 (1973) (Court-reviewed); * * *. No sale occurs if the transferor retains proprietary rights in the motion picture. See *Carnegie Productions, Inc. v. Commissioner, supra* at 653; *Cory v. Commissioner*, 23 T.C. 775 (1955), affd. 230 F.2d 941 (2d Cir. 19[illegible]). * * * [Fn. refs. omitted.]

See also *Law v. Commissioner*, 86 T.C. 1065 (1986).

After thorough consideration of the facts and circumstances of this case we find that Lorelei and its partners became a joint venturer with a 25-percent interest in the film "Overboard."

Factor acquired a script or screenplay and produced a movie at a cost of $1,487,445. During November 1977, Factor entered into an agreement to license NBC to televise the movie 2 times over a 3-year period for $1,190,000. During May 1978, Factor and Lorelei entered into their agreement. During June 1978, Factor entered into an agreement to license to Time-Life the rights to the movie without geographical limitation, except for "French Polynesia," for a 20-year renewable period, basically beginning at the end of NBC's license. Time-Life's license did not include the theatrical rights. In exchange, Time-Life was to pay Factor an advance of $300,000 (payable over about 5 years) and the balance of any gross receipts after reduction for Time-Life distribution charges, expenses, and any advances paid to Factor.

Under the May 1978 agreement between Lorelei and Factor, Lorelei was to receive the (photoplay) movie subject to the NBC and Time-Life licenses, which, in effect, conveyed Factor's retained right to use the photoplay for theatrical purposes.[11] Further, Lorelei was to receive the $1,190,000 due from NBC, the $300,000 advance from Time-Life, and approximately 25 percent of the "net profits" from the amounts originally payable to Factor by Time-Life. The purchase price to be paid by Lorelei was stated as $2,390,000. Of the $2,390,000 purchase price, $1,640,000 was payable upon specified dates or occurrences and not dependent upon the existence of "net [profits]." The remaining $750,000 was only payable to Factor if "net [profits]" were realized. Further, the $750,000 was payable to Factor as its part of a split (75 percent Factor—25 percent Lorelei) of the residue, after all other expenses and charges are paid.

It is no coincidence that the $1,640,000 unconditional portion of the purchase price is exactly equal to the total of the unconditional payments to be made by NBC ($1,190,000), Time-Life ($300,000) and the "cash investment" of Lorelei limited partners attributable to the movie ($150,000).[12]

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[11] No evidence was supplied regarding the value of the theatrical rights or whether there was an intention to use or any actual use of the theatrical rights to "Overboard."

[12] It is also more than coincidental that the "purchase price" to be paid by Lorelei ($2,390,000) provided sufficient depreciation in each of the 3 years before the Court to limit the taxable income or loss from the movie to less than 1 percent of the gross receipts from NBC and Time-Life. Accordingly, limited partners reported a nominal amount of gain or loss, but claimed an investment tax credit approximating 75 percent of their cash investment.

It is also most curious and revealing that the $1,640,000 unconditional portion of the purchase price to be paid by Lorelei is nearly[13] equal to Factor's production cost ($1,487,445) plus the "cash investment" of the Lorelei limited partners. Accordingly, after consideration of all unconditional payments, as between Factor and Lorelei, only Lorelei is "out of pocket" ($150,000) and Factor has received a markup of approximately 10 percent on production costs. Beyond the $150,000, the limited partners of Lorelei have no personal or partnership obligations, unless the license agreement with Time-Life produces revenues in excess of charges, expenses of distribution, and advances. If an excess occurs, that excess revenue will provide the sole source of payment under the agreements to satisfy any of Lorelei's obligations over $150,000.

To the extent that the Time-Life license does produce excess revenue, Factor is to receive 75 percent and Lorelei is to receive 25 percent. As previously indicated, the $750,000 "conditional portion" of the purchase price to be paid by Lorelei is to be part of Factor's 75-percent split. Once the $750,000 is received by Factor, all further "net profits" are to be split 75 percent for Factor and 25 percent for Lorelei. Accordingly, to the extent that the movie was successful beyond the $1,490,000 to be received from NBC and Time-Life, Lorelei and Factor were "partners" or they jointly ventured to share profits from the exploitation of the photoplay.

Factor and Lorelei did stand to share losses in a similar ratio to profits. The ratio in which losses would have been borne is not defined but in effect would be similar to the 75- to 25-split of profits. From the first "excess revenues" to be received from Time-Life, Lorelei was to receive $75,000, only, preceded by any residuals that Factor may have been obligated to pay regarding the televising of the movie. Thereafter, Factor was to receive $59,500, which was payable to the William Morris Agency. Then Lorelei was entitled to $40,000 of the next $100,000. At this point, Lorelei is on a par with Factor to the extent that both are relatively "cashed-out" of the transaction and thereafter they begin sharing profits at the 75 to 25 split. Accordingly, Lorelei stood to lose its $150,000, which it put up on the front end and Factor stood to lose its $750,000, receipt of which was deferred at least until after 3 years, if the Time-Life license did not return a profit. Although $750,000-$150,000 does not mathematically equate to a 75 to 25 split, the ratio would more closely approach 75 to 25 if one considers the timing and nature of the two amounts. Lorelei paid the $150,000 at the outset and stood to lose that amount if the venture was unsuccessful.[14] On the other hand, Factor was "guaranteed" $750,000 as part of a designated division of profits which it would "lose" if the movie were unsuccessful. That amount relates to Factor's investment of labor and time in the production of the movie, which represents its portion of the investment in the venture to exploit the photoplay.[15]

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[13] Factor's production costs ($1,487,445) plus the Lorelei "cash investment" ($150,000) is less than one-seventh of 1 percent short of the $1,640,000 unconditional payments to be made by Lorelei.

Although the legal title to the copyright was held and registered in Factor's name, Lorelei was entitled to have it registered in its name after the first showing by NBC. The agreement recited that Factor held the title "in trust" for Lorelei and that it would be assigned upon Lorelei's "request made at any time after the first domestic syndication broadcast of the Photoplay."[16] Even if Lorelei had requested assignment of the copyright, there remained sufficient restriction upon its use (because of the NBC and Time-Life licenses) and control by Factor so as to require the consent or participation of both Factor and Lorelei to exploit or profit from the movie.

If the agreement between Lorelei and Factor is to be respected, Lorelei, at very least, received a shared interest in the photoplay. In addition to the NBC license and potential theatrical rights, Lorelei acquired a 25-percent interest in the profits from the Time-Life license, which license could have produced revenues over a 40-year period, after which the distribution rights would have reverted back to Factor and Lorelei. We must assume that NBC and Time-Life would not pay over or advance nearly $1.5 million for a license unless it had promising potential. If unsuccessful, Lorelei would lose its $150,000 investment and Factor its time and effort in the production, beyond the $150,000 received from Lorelei.

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[14] This analysis does not consider possible tax benefits which are the subject of this case.

[15] Surely the $150,000 amount received (approximately 10 percent of the production costs) would not adequately compensate Factor for production and marketing of the movie.

[16] The record is silent as to whether Lorelei ever requested assignment of the copyright.

At the time of the "May 1978 Lorelei agreement" the NBC license had been contracted for and the Time-Life license agreement was likely under consideration. Moreover, the production of the photoplay was not complete and Factor received part of the consideration from Lorelei which was available for use by Factor to pay for part of the $1,487,445 production costs.

Considering the foregoing, we are convinced that the movie was a viable property and that Lorelei had acquired an ownership interest that would entitle its limited partners to claim both depreciation and investment tax credit. We do not find, however, that the ownership interest was acquired, as alleged, by means of a purchase and sale of the photoplay. This transaction was not a transfer of property for money or a promise of payment. *Commissioner v. Brown*, 380 U.S. 563 (1965). Instead, the transaction is one where Lorelei was permitted to join the owner of a photoplay and producer of a movie to jointly own, exploit, and participate in the profits from the subject asset. Factor did not give up all of its interest nor did Lorelei acquire unfettered right, but rather the parties now share the asset in a joint venture. See *Podell v. Commissioner*, 55 T.C. 429, 431 (1970), and cases cited therein. Further, their joint venture falls within the definition of a partnership for Federal income tax purposes. *Long v. Commissioner*, 77 T.C. 1045, 1064-1065 (1981). The facts of this case are distinguishable from those set forth in *Tolwinsky v. Commissioner*, 86 T.C. 1009 (1986), and *Law v. Commissioner*, 86 T.C. 1065 (1986).

It is well established that the economic substance of a transaction, rather than its form, controls for Federal tax purposes. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Derr v. Commissioner*, 77 T.C. 708 (1981). We must be concerned with the economic realities and not necessarily the form employed by the parties. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Estate of Franklin v. Commissioner*, 64

T.C. 752 (1975), affd. on other grounds 544 F.2d 1045 (9th Cir. 1976).

As important, we should not disregard the existence of an asset for which Congress intended tax advantages merely because the parties attempted to maximize the advantage of those benefits for one of the parties to a transaction. Respondent should recognize that in instances where there are no shams and depreciable assets exist, some person or entity is entitled to the intended tax advantages.[17] See *Estate of Thomas v. Commissioner*, 84 T.C. 412, 433-440 (1985). Petitioner, on the other hand, has overreached in arguing that he is entitled to depreciation and investment tax credit based upon the premise that Lorelei owned 100 percent of the photoplay.

The depreciation available to Lorelei and Factor, as joint owners, is dependent upon the basis in the asset. Sec. 167(g). Sections 1011 and 1012, read in conjunction with section 167(g), provide that depreciable basis shall be the properties' cost.[18] Because we have found that Lorelei and Factor have become joint venturers in the production and exploitation of the movie "Overboard," they are limited to the production costs of $1,487,445 as their basis for purposes of depreciation. The $2,390,000 stated sales price was merely established to cause the annual depreciation to "neutralize" the revenues anticipated from the NBC and Time-Life contracts. Accordingly, the parties will be required to recompute depreciation which will increase the amount of net income realized from the license revenues. Respondent disallowed all depreciations claimed by petitioners through their interest in Lorelei. Petitioners bear the burden of proving their depreciable basis and their entitlement to deductions, including depreciations. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142. The record in this case, considering that we are unable to agree with petitioners that they purchased an exclusive interest in the movie, does not support a basis for depreciation in excess of the production costs of $1,487,445.[19]

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[17] The tax advantages may, of course, be limited or unallowable because of statutory provisions. See, for example, sec. 183.

[18] Respondent has not questioned the fair market value of the photoplay but has placed his reliance upon lack of an ownership interest.

The investment credit available with respect to a motion picture film is set forth in section 48(k)(1)(A) and is based upon a taxpayer's "ownership interest." Section 48(k)(1)(C) equates "ownership interest" with the taxpayer's "proportionate share of any loss which may be incurred with respect to the production costs ." If one has an "ownership interest", i.e., a "depreciable interest", in at least a part of a qualified film, part or all of the investment tax credit may be claimed. Sec. 1.48-8(a)(4)(i), Income Tax Regs. Only $1,393,239 was claimed as basis for qualified property subject to the investment tax credit in Lorelei partnership returns for the 1978 and 1979 taxable years.[20] We find that Lorelei and its limited partners became a joint venturer with Factor at a time when the production of the movie was ongoing. Further, the $150,000 paid to Factor by Lorelei is to be considered as payment for a 25-percent interest in profits and losses in the joint venture. In view of the foregoing, Factor and Lorelei are found to be "owners" in their respective percentage loss ratio of the movie "Overboard" within the meaning of section 1.48-8(a)(4)(i) of the regulations.

We accordingly find that Lorelei owned a 25-percent interest in the movie and that petitioner is entitled to claim, through Lorelei, depreciation and investment tax credits in accord with his percentage interest in Lorelei. Due to our holding, the receipts, deductions, and credits attributable to the movie have, to some extent, been overstated by Lorelei and petitioner and must be adjusted accordingly. The amount of depreciation must be reduced to reflect the joint venture's basis, which is cost, and not the proposed purchase price.

Petitioners bear the burden of proof with respect to the delinquency addition to tax under section 6651(a) for the taxable year 1980. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142. Petitioners' appear to have abandoned this issue as it is not mentioned in their briefs and no evidence w offered on their behalf. We therefore sustain respondent determination concerning an addition to tax for 198 pursuant to section 6651(a).

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[19] Neither party has cited sec. 280. which requires individuals to capitalize the production costs of motion pictures, among other assets, and to amortize such costs under an income forecast method, and, accordingly, we make no comment thereon.

[20] For 1978, $1,348,844 was shown as qualified property for computation of the credit, and $44,395 was shown for that purpose for 1979.

To reflect the foregoing and concessions of the partie

Decisions will be entered under Rule 15

JOHN J. TOKARSKI, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 19239-85. Filed July 14, 1986.

Petitioner deposited cash in a bank account and the trial record revealed no income-producing activity on his part. *Held*, under these circumstances, respondent does not have the burden of going forward with evidence linking petitioner to an income-producing activity as a precondition to requiring petitioner to satisfy his burden of proof. *Held, further*, petitioner has failed to carry his burden of proof.

Philip B. Abramowitz, for the petitioner.
Stephen C. Best, for the respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined a de ciency in petitioner's Federal income tax for 1981 in t amount of $11,722, together with an addition to tax of $5 under section 6653(a)(1),[1] and an additional amount to determined[2] under section 6653(a)(2). The issues for decisi are (1) whether a bank deposit constitutes taxable incom and (2) whether petitioner is liable for the additions to t for negligence or intentional disregard of rules and regul tions. For convenience, we have combined our findings fact and opinion.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in eff during the taxable year at issue, and all Rule references are to the Tax Court Rules of Pract and Procedure.

[2] The $586 was the only addition to tax set forth in the notice of deficiency but attachments to the notice explained that an additional amount consisting of 50 percent of interest payable with respect to the $11,722 was being determined.

Petitioner resided in Buffalo, New York, at the time the petition was filed. He filed a timely Federal income tax return for 1981 with the Andover Service Center.

On July 27, 1981, petitioner deposited $30,000 in cash with the Manufacturer's Hanover Bank and received therefor a Certificate of Deposit. Petitioner did not include the $30,000 in income on his 1981 return but he did include the interest earned on that account.[3]

Petitioner's mother testified that she gave the $30,000 to petitioner; that the funds came from her husband, Frank Tokarski (petitioner's father), when he died in May 1976; that the father had accumulated cash which he had kept in a cigar box in a closet in their home; that, around Christmas of 1975 after her husband had had a heart attack, he told her to give the cash to their son (petitioner) when he reached the age of 27; that he picked that age because he felt that by that time petitioner would be more mature; that her husband did not believe in banks; and that she gave the cash to petitioner when he reached 27 on June 11, 1981. Petitioner also testified that his father had wanted him to have the money on his 27th birthday and that he did not deposit it immediately because it took him 6 weeks to convince his mother that it should be so deposited. Petitioner further testified that he was unemployed during 1980 and 1981 and in fact never has worked at all; that he received free room and food by living with his mother; and that he received $30 to $40 a week from his two uncles who lived with him and his mother, with which he purchased gas for his car, paid for his insurance, and had "money to go out with".

In the usual case, petitioner would have the burden of proof as to all issues involved herein. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Petitioner contends, however, that before that burden can be imposed upon him, respondent has the burden of going forward with evidence linking him to an income-producing activity, which respondent has not satisfied herein. In so contending, petitioner relies on *Llorente v. Commissioner*, 649 F.2d 152 (2d Cir. 1981), affg. in part, revg. in part, and remanding 74 T.C.

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[3] The deficiency notice included $1,685 of interest income which respondent has conceded was incorrect.

260 (1980), and *Jackson v. Commissioner*, 73 T.C. 394 (1979). If *Llorente* is applicable, we would be required to sustain petitioner's contention. *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971). See also *Dellacroce v. Commissioner*, 83 T.C. 269, 287 (1984). We are satisfied, however, that both *Llorente* and *Jackson* are distinguishable. In both cases, respondent reconstructed the taxpayer's income and there was no evidence that the taxpayer had *actually received anything* during the period in issue.[4] Likewise, in *Dellacroce*, there was no admissible evidence that the taxpayer therein had received any funds to which the alleged bribe could be linked. Furthermore, in none of these cases was there any evidence from which the actual receipt of funds could be inferred. Compare *Shriver v. Commissioner*, 85 T.C. 1 (1985). See also *LaBow v. Commissioner*, 763 F.2d 125 (2d Cir. 1985), affg. in part, revg. in part, and remanding a Memorandum Opinion of this Court, in which the Second Circuit Court of Appeals noted that in the case *sub judice* "the IRS did not have any factual basis for asserting that [x] received or benefited from [y's] claimed payments." 763 F.2d at 132.[5]

In the instant case, however, there is no question that petitioner received $30,000 in 1981. Under these circumstances,[6] we hold that there is no requirement that respondent produce evidence linking petitioner to an income-producing activity as a precondition to requiring petitioner to meet his burden of proof. We turn to the question of whether petitioner has satisfied his burden.

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[4] Petitioner submits the following quotation from *Jackson v. Commissioner*, 73 T.C. 394 (1979), which suggests that the taxpayer did receive property: "the Government managed to seize $54,715 in cash plus an Eldorado Cadillac at the time of petitioner's arrest." The full quotation is as follows [73 T.C. at 399]:

"Notwithstanding the petitioner's almost total lack of funds or source of income in 1970 [the only year before the Court] (if his testimony is to be believed), the Government managed to seize $54,715 in cash plus an Eldorado Cadillac at the time of petitioner's arrest on July 8, 1971, on the suspicion of dealing in narcotics, according to the opening statement of respondent's counsel. The record contains absolutely no explanation of the source of these funds or property, and, in fact, respondent's counsel categorically stated that 'respondent maintains that the cash seized in 1971 has no bearing at all on the issue before this Court in the 1970 year.' "

[5] See also *Walker v. Commissioner*, 757 F.2d 36 (3d Cir. 1985), revg. and remanding a Memorandum Opinion of this Court, where direct evidence as to the actual receipt of funds or an income-producing activity was absent.

[6] Most of the cases requiring proof of a linkage to an income-producing activity have involved alleged illegal sources of income. We leave to another day whether that requirement should be limited to such cases. See *Anastasato v. Commissioner*, T.C. Memo. 1985-101; *Adamson v. Commissioner*, T.C. Memo. 1982-371, affd. 745 F.2d 541 (9th Cir. 1984). But cf. *LaBow v. Commissioner*, 763 F.2d 125 (2d Cir. 1985), affg. in part, revg. in part, and remanding a Memorandum Opinion of this Court.

A bank deposit is prima facie evidence of income and respondent need not prove a likely source of that income. *Estate of Mason v. Commissioner*, 64 T.C. 651, 656-657 (1975), affd. 566 F.2d 2 (6th Cir. 1977). As previously noted, petitioner and his mother testified that the source of such income was cash accumulated by petitioner's father. Against this testimony stands the fact that respondent, in an effort to negate that explanation, investigated the assets of the father at the time of his death and submitted convincing evidence that the records of the New York Surrogate Court contained no evidence of any cash on hand. As also previously noted, petitioner testified that he had never worked and that he received funds to live on from his uncles. That petitioner, who appeared to us to be a normal, healthy person and was 32 years of age at the time of the trial, had never been productively occupied strains credulity. Moreover, the fact petitioner did not offer any corroborative testimony from his uncles or offer any explanation for not so doing weighs against him. *Blum v. Commissioner*, 59 T.C. 436, 440-441 (1972), and the cases cited therein.[7] Finally, we are unpersuaded that petitioner's delay of approximately 6 weeks between the date of his 27th birthday and the date of the deposit was attributable to his father's lack of confidence in banks. Under all the circumstances, we are not required to accept the self-serving testimony of petitioner or that of his mother as gospel. *Fleischer v. Commissioner*, 403 F.2d 403, 406 (2d Cir. 1968), affg. a Memorandum Opinion of this Court; *Leong v. Commissioner*, T.C. Memo. 1977-19, affd. without published opinion 573 F.2d 1291 (2d Cir. 1977).[8]

In sum, we hold that petitioner has failed to carry his burden of proof that the $30,000 was not taxable income. We further hold that, absent any evidence beyond that submitted with respect to the taxability of the $30,000, petitioner has also failed to carry his burden of proof with respect to the additions to tax under section 6653(a)(1) and (2).

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[7] See also *Verra v. Commissioner*, T.C. Memo. 1972-199, affd. 474 F.2d 1336 (2d Cir. 1973).

[8] See also *Ross v. Commissioner*, T.C. Memo. 1978-380.

To reflect respondent's concession (note 3, *supra*),

Decision will be entered under Rule 1

CHARLES W. WARD AND VIRGINIA P. WARD, PETITIONE *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDEN

Docket No. 30068-83. Filed July 16, 1986.

In 1940, H entered into a land contract to purchase ranch land in Florida. Over the next 4 years, H and his wife, W, each contributed indeterminate amounts of money to pay the installments of the purchase price of the ranch land and to acquire an adjacent parcel of ranch land. H took title to both parcels in his name alone. In 1978, H and W deeded the ranch land to a newly formed corporation, J, except for three small plots deeded as gifts to their sons and their wives. In return for the ranch, H and W each received 43.7 percent of the stock in J. The three sons of H and W contributed cattle and depreciable assets to J, and in return, each son received 4.2 percent of the corporate stock. In 1979, 1980, and 1981, H and W made gifts of minority stock interests in J to each of their sons. At the time of each gift of stock, the parties to the gift executed a gift adjustment agreement which provided that if it were finally determined for Federal gift tax purposes that the fair market value of the stock exceeded or was less than the value ascribed to the stock in the agreement, the number of shares given would be decreased or increased so that the total value of the gift would equal the amount fixed in the agreement. *Held*:

1. H did not make a gift to W of the J stock that she received upon the contribution of the ranch to the corporation because W was the beneficial owner of an undivided one-half interest in the ranch by virtue of a resulting trust.

2. The number of acres of land given to the sons and their wives is determined.

3. The fair market value of the gifts of J stock as of the date of each gift in 1979 through 1981 is determined. In valuing the gifts of stock, discounts for lack of control and lack of marketability are warranted, even though all of the corporation's stock is owned by members of a single family.

4. The gift adjustment agreements do not affect the gift taxes otherwise due on the gifts of stock.

Joseph D. Edwards, *Olin G. Shivers*, and *Jeffrey M. D* for the petitioners.

Francis C. Mucciolo, for the respondent.

SIMPSON, *Judge*: The Commissioner determined deficiencies in the petitioners' Federal gift taxes as follows:

Petitioner	*12/31/78*	*12/31/79*	*12/31/80*	*3/31/81*
Charles W. Ward	$201,802.14	$99,276.29	$11,997	$14,920.34
Virginia P. Ward	---	39,090.00	9,882	11,271.70

The issues for decision are: (1) Whether Charles W. Ward made a gift to his wife, Virginia P. Ward, of 437 shares of stock in J-Seven Ranch, Inc. (J-Seven), in 1978, and if so, the value of such shares; (2) the number of acres of land given to the petitioners' sons and their wives in 1978; (3) the fair market values of gifts of stock in J-Seven made by the petitioners to their sons in 1979, 1980, and 1981; and (4) if the fair market values of such gifts of stock are greater than was reported on the petitioners' gift tax returns, whether agreements executed by the petitioners and their sons at the time of the gifts providing in such event for a reduction of the number of shares given, so as to avoid gift tax liability, are effective for Federal gift tax purposes.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioners, Charles W. and Virginia P. Ward, husband and wife, maintained their residence in Florida[1] at the time they filed their petition in this case. Mr. and Mrs. Ward each filed Federal gift tax returns for the calendar quarters ending December 31, 1978, December 31, 1979, December 31, 1980, and March 31, 1981, with the Internal Revenue Service Center, Atlanta, Georgia. We shall refer to a calendar quarter by the calendar year of which it is a part.

Mr. and Mrs. Ward were married on September 13, 1939. They have five children: Virginia, Charles, Jr., Mary, William, and John.

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[1] The parties have stipulated that the petitioners resided in Clewiston, Flordia, the mailing address of J-Seven and the address stated on their gift tax returns. However, other evidence indicates that the petitioners actually resided in Fort Myers, Flordia, at the time they filed their petition.

When they were first married, the petitioners rented a home in Fort Myers, Florida, for $35 per month. Since then, they have always resided in Fort Myers, eventually buying a home sometime after 1944. Fort Myers is located in Lee County.

Mr. Ward, an attorney, was appointed County Judge of Lee County on March 1, 1939, and he remained in that office through at least 1944. The judicial appointment was a full-time position, requiring that Mr. Ward be at the county courthouse from 9 a.m. to 5 p.m. on weekdays and from 9 a.m. to 1 p.m. on Saturdays. Mr. Ward's income from his position as County Judge ranged from about $3,000 to $4,000 per year. Mrs. Ward was unemployed at the time of the petitioners' marriage in September 1939. Sometime after the Japanese attack on Pearl Harbor in December 1941, she went to work for her father. Her father had been awarded a contract to build a railroad from Fort Myers to the Buckingham Gunnery School east of Fort Myers, and he employed Mrs. Ward to prepare his payroll and to perform other bookkeeping tasks. The record does not establish how much her father paid Mrs. Ward, but it was more than was customary for the type of work because Mrs. Ward worked long hours and on weekends when necessary and because he knew that Mr. and Mrs. Ward were in need of the extra income. Mrs. Ward stopped working for her father sometime before the birth of her son Charles, Jr., on February 14, 1944.

At the time of their marriage, the petitioners had no assets other than some cattle owned by Mr. Ward. Mr. Ward was raised on a farm and has always been interested in cattle. Sometime before he married, Mr. Ward purchased 25 head of cattle, which he ran on open range land in Collier County, Florida, together with cattle owned by his brother, David Elmer Ward. In November 1940, Mr. Ward borrowed money from the Lee County Bank in order to buy an additional 200 head of cattle. These 200 head of cattle were kept on ranch land leased from the Florida Land & Timber Co. (FLT) and located in Hendry County, Florida.

On December 21, 1940, Mr. Ward (as Wilson Ward) entered into a contract with FLT for the purchase of the

Hendry County land (the land contract). Under the contract, FLT agreed to sell Mr. Ward:

> Sections Nineteen (19), Twenty (20), Twenty-one (21), Twenty-eight (28), Twenty-nine (29), Thirty (30), Thirty-one (31) and Thirty-two (32), Township Forty-six (46) South, Range Thirty-three (33) East, totaling eight (8) sections, all in Hendry County, Florida, subject to existing roads and easements for roads.

The eight sections contained approximately 5,120 acres. Mr. Ward agreed to pay FLT $7,680 (plus interest) for the land, payable in installments of principal as follows:

Date	*Principal payment*
Upon execution of the contract	$2,560
Feb. 24, 1942	1,706
Feb. 24, 1943	1,707
Feb. 24, 1944	1,707

The principal balance due was subject to interest at a rate of 5 percent per annum from February 24, 1941, payable on August 24, 1941, and semiannually thereafter, until the principal was fully paid.

The land contract entitled Mr. Ward to possession of the property on February 24, 1941, and thereafter so long as he performed the obligations of the contract. The land contract further provided that:

> It is further agreed and understood that the party of the first part [FLT], under date of December 21, 1940, is to execute a deed to Wilson Ward and David Elmer Ward, and, subject to the conditions and reservations hereinbefore stated, deliver such deed promptly to the First National Bank in Fort Myers, Florida, in escrow.
>
> * * * * * * *
>
> But if all said sums of money, interest and taxes are paid, as aforesaid, promptly at the times aforesaid, and all agreements on the part of the said party of the second part [Wilson Ward] have been complied with, the party of the first part will, on receiving all said money and interest, and upon the surrender of the duplicate of this contract, execute and deliver or cause to be executed and delivered, to said second party, his heirs or assigns, a good and sufficient warranty deed, conveying said premises in fee simple * * *

The land contract provided that David Elmer Ward was to be a grantee in the escrow deed because he was considering joining in the purchase so as to have a place to run his cattle; but shortly thereafter, he purchased land elsewhere

in Hendry County and decided not to join in the purcha
from FLT. FLT never placed a deed in escrow.

Mr. Ward consulted his wife before he entered into th
land contract with FLT. They agreed that the land ought
be purchased. Mr. Ward paid the $2,560 downpayment
the land. After Mrs. Ward began working in 1942, h
wages and those of Mr. Ward were deposited in a joi
bank account. Proceeds from the sale of cattle belonging t
one or the other or both of them were also deposited int
their joint bank account. The petitioners paid the instal
ments of principal and interest payments due FLT wit
money drawn from their joint account. They did not keep
record of the amounts each contributed to the account or t
the purchase from FLT.

After the petitioners paid the last installment of princip
and interest due FLT, the president of FLT, on March 24
1944, executed a deed conveying to Wilson Ward (th
petitioner, Charles W. Ward) a fee simple interest in th
eight sections of land described in the land contract. I
such deed, FLT retained all oil, gas, and mineral rights t
the land, contrary to the terms of the land contract. O
November 24, 1944, the president of FLT executed
corrected deed wherein the provision concerning oil, ga
and mineral rights conformed to the land contract. In both
deeds, Mr. Ward was the sole grantee. Mr. Ward had both
deeds recorded in the public records of Hendry County.

On October 7, 1942, Marion C. and Helen M. Ryan (th
Ryan sisters) conveyed section 33 of Township 46 South,
Range 33 East, Hendry County, to Mr. Ward, as sol
grantee. Section 33 was adjacent to the eight sections o
land purchased from FLT. The deed was prepared at the
direction of Mr. Ward and recorded on October 29, 1942.
Mr. Ward paid $1,152 for the property, using funds drawn
from the petitioners' joint bank account.

The nine sections of land purchased from FLT and the
Ryan sisters (the ranch) contained a total of about 5,712
acres, or almost 9 square miles of land. The ranch was
situated about 20 miles southwest of Clewiston and about
55 miles southeast of Fort Myers. The land was suitable
primarily for cattle ranching. From 1941 until the incorporation of the ranch in 1978, the petitioners have maintained

cattle on the land. Their sons have also run cattle on the ranch.

The petitioners have always felt that they were co-equal owners of the ranch because they both contributed money toward its purchase and because they both worked on the ranch. During the years when the property was being purchased and both Mr. and Mrs. Ward were employed in Fort Myers, they went to the ranch to check on the cattle only on weekends. In subsequent years, Mrs. Ward continued to help with the ranch by cooking for ranch crews, carrying supplies between Fort Myers and the ranch, and occasionally helping with the cattle.

Mr. Ward prepared a deed conveying a one-half interest in the ranch to Mrs. Ward; an executed copy of the deed has not been located, and Mrs. Ward does not recall receiving the deed. The deed was never recorded. An unexecuted copy of the deed, entitled "Special Deed" and dated March 23, 1943, recites, in part, as follows:

> WITNESSETH: That the said party of the first part [Charles Wilson Ward], for and in consideration of the sum of One and No/00 ($1.00) dollars and the other considerations hereafter set forth, does hereby convey and transfer to his wife, the said party of the second part [Virginia Powell Ward], her heirs and assigns forever, the title to an undivided One-half (1/2) interest in the following described lands, situate, lying and being in Hendry County, State of Florida, to-wit:
>
> Sections 19, 20, 21, 28, 29, 30, 31, 32 and 33 of Township 46 South, Range 33 East, less easements for road right-of-way.
>
> These lands were purchased by the said party of the first part and the said party of the second part with their joint monies and the deed from Florida Land and Timber Company and the deed from Marion C. Ryan and Helen M. Ryan should have been made and executed to both of said parties.
>
> This deed is given directly from husband to wife for the purpose as shown and not to avoid the collection of any just debt or other obligation of either of the said parties hereto.
>
> The wife, party of the second part, does not execute this deed for the purpose of relinquishing her dower rights in said lands as the interest therein created by this deed is greater than said dower.

The names of the grantor (Charles Wilson Ward), two witnesses, and a notary public are typed in the appropriate places at the bottom of the copy of the unexecuted deed. The deed is obviously old; certain holes in, and marks on the face of, the deed appear to have been caused by either the decomposition of the paper or water damage.

On October 17, 1978, Mr. and Mrs. Ward joined in giving portions of the ranch to their sons and their wives. Charles, Jr., and his wife, Frenda, received a rectangular parcel of land, measuring 800 feet by 484 feet, located in section 28. Such parcel contained 387,200 square feet, or 8.9 acres, of land. (There are 43,560 square feet in an acre, 640 acres in a section, and 36 sections in a township. Webster's Third New International Dictionary (1981).) William and his wife, Barbara, received a rectangular parcel in section 20, measuring 1,000 feet by 435.6 feet and containing 435,600 square feet, or 10 acres, of land. John, who was unmarried, received land described as follows:

> The south one-half (S 1/2) of the northwest quarter (NW 1/4) and the north one-half (N 1/2) of the southeast quarter (SE 1/4) of the northwest quarter (NW 1/4) of the southwest quarter (SW 1/4) of Section 28, Township 46 South, Range 33 East[.]

We have concluded that such description conveyed 10 acres of land to John.

The petitioners intended to give each son 10 acres of land, and the sons thought that they had each received 10 acres; but, through some error of description or calculation, Charles, Jr., actually received only 8.9 acres. Charles, Jr., discovered that he had received only 8.9 acres in 1979, when a property tax bill arrived. Sometime thereafter, he told his father of the mistake. As of the time of trial, nothing had been done to correct the mistake.

In September 1978, the petitioners and their sons formed J-Seven Ranch, Inc., to provide for an orderly transfer of the ranch from the petitioners to their sons and to ensure that the cattle business would continue as a single economic unit after the petitioners' deaths. J-Seven was capitalized in December 1978; Mr. and Mrs. Ward, as co-grantors, deeded the ranch (less the three parcels previously conveyed to their sons and their wives) to the corporation, and each of their sons contributed 400 head of cattle and certain depreciable assets to the corporation. No cash was contributed to J-Seven. The ranch, as deeded to J-Seven, contained 5,683.1 acres, or 1.1 acres more than intended, due to the mistake in the deed to Charles, Jr.

J-Seven had 7,500 authorized shares of stock, of which 1,000 shares were issued and outstanding during the years in issue. When the corporation was formed, shares were issued to the following persons in the listed amounts:

Name	*Shares*
Charles W. Ward	437
Virginia P. Ward	437
Charles, Jr	42
William	42
John	42

On March 10, 1979, J-Seven and its five stockholders entered into a stock purchase agreement, which recited in pertinent part as follows:

ARTICLE I

Restrictions on Transfers

1. *Restrictions*. No Stockholder shall transfer or pledge all or any portion of his shares of capital stock of the Corporation to any individual, trust, or corporation, for value without the written consent of the other Stockholders, unless the Stockholder desiring to make the transfer (hereinafter referred to as the Transferor) shall have first offered to sell or encumber his shares of stock as hereinafter provided. Further, no Stockholder shall transfer all or any portion of his stock to any individual, trust or corporation without consideration unless he shall have first received the written consent of the other Stockholders.

2. *Offer to Other Stockholders*. The Transferor shall first offer to sell or encumber his stock to the other Stockholders and the Corporation * * *. In the event of a proposed sale, the other Stockholders shall have thirty (30) days in which to acquire pro rata shares of the offered stock as determined by their stock ownership at the time of the offer, on the terms set forth in the notice or for cash at the price designated in Article III determined as of the date of such notice. In the event of a proposed loan, the other Stockholders may lend money in proportion to their respective stock ownership on the proposed terms * * *

3. *Offer to Corporation*. In the event the other Stockholders shall fail to fully exercise their option within the period specified in paragraph 2, the Corporation shall have forty-five (45) days from the date written notice was delivered to it and the other Stockholders in which to exercise its option, (1) in the event of a proposed sale, to purchase any remaining stock on the terms of the proposed sale or for cash at the price designated in Article III or, (2) in the event of a proposed loan, to loan money on the proposed terms * * *

* * * * * * *

5. *Failure to Exercise Options*. If all the Stockholders and the Corporation fail to fully exercise their options within the prescribed

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period, the Transferor may transfer his interest in the stock (or any remaining stock) to the person or persons designated in the offer * * * Any transferee shall take his stock subject to the terms of this Agreement and further transfer of the stock shall be restricted as herein provided. * * *

* * * * * * *

ARTICLE II

Sale and Purchase at Death

1. *Purchase Upon Death.* Upon the death of a Stockholder (hereinafter referred to as the Decedent) all of the shares of the capital stock of the Corporation owned by him and to which he or his personal representative shall be entitled, shall be sold and purchased as herein provided.

2. *Option of Other Stockholders to Purchase.* The other Stockholders shall have six (6) months following the death of the Decedent in which to purchase in pro rata shares * * * the capital stock of the Corporation owned by the Decedent and to which the Decedent or his personal representative shall be entitled at the price set forth in Article III hereof determined as of the date of the Decedent's death. * * *

3. *Obligation of Corporation to Purchase.* The Corporation shall purchase from the Decedent's personal representative and the Decedent's personal representative shall sell to the Corporation all of the shares of the capital stock of the Corporation not purchased by the other Stockholders and which are owned by the Decedent and to which the Decedent or his personal representative shall be entitled, at the price determined as set forth in Article III hereof.

4. *Payment of Purchase Price.* At the closing the purchase price shall be paid by the delivery of a promissory note or notes of the purchaser or purchasers in the amount of the purchaser's share of the purchase price, payable in twenty (20) equal annual installments * * * . The note or notes shall bear interest at the rate of six percent (6%) on the unpaid balance.

* * *

* * * * * * *

ARTICLE III

Purchase Price

1. *Certificate of Value.* The price of the stock of the Corporation shall be determined by using the price per share as fixed in the latest certificate of value executed during the term of this Agreement by all of the Stockholders and the Corporation, provided that such certificate of value shall be dated not earlier than two (2) years prior to the valuation date.*** Simultaneously herewith, the parties hereto have executed a certificate of value, a copy of which is attached to this Agreement.

2. *Untimely Certificate.* In the event that the Stockholders and the Corporation shall have failed to fix a price within two (2) years of the valuation date, then the price of the stock per share shall be agreed upon by the Transferor or the Decedent's personal representative (hereinafter the "Seller") and the several purchasers, if more than one. In the event that the Seller and one or more purchasers shall be unable to agree upon the price of the stock per share, the price per share shall be fixed by an appraiser * * *

ARTICLE IV
Miscellaneous Provisions

1. *Corporate Restrictions after Purchase.* So long as any part of the purchase price of the shares of capital stock sold in accordance with this Agreement remains unpaid, the Corporation shall not: declare or pay dividends on its capital stock; reorganize its capital structure (except to reduce its capital as required by the provisions of Article II, Section 5 hereof); issue any additional stock; merge or consolidate with any other corporation; or sell any of its assets except in the regular course of business. * * *

* * * * * * *

8. *Modification.* No change or modification of this Agreement shall be valid unless the same be in writing and signed by all parties hereto.

In accordance with Article III of the stock purchase agreement, the stockholders of J-Seven, on March 10, 1979, executed a certificate of value, which fixed the price of the corporation's stock at $2,000 per share for purposes of the agreement. The stockholders have not executed another certificate of value since that time. There have been no sales of, or attempts to sell, any of the shares of stock of J-Seven through 1984.

On December 28, 1979, each of the petitioners gave to each of their three sons 25 shares of stock in J-Seven. At the time of such gifts, the petitioners and their sons executed an agreement (the gift adjustment agreement) that stated, in pertinent part:

1. *Assignment.* In consideration of love and affection, each Donor does hereby assign to each Donee all of the Donor's right, title and interest in and to twenty-five (25) shares of the capital stock of J-SEVEN RANCH, INC., a Florida corporation, hereinafter called the "Corporation". The parties acknowledge that the computation of the number of shares constituting each gift has been based upon their mutual understanding and belief that the fair market value of each share is $2,000.00, resulting in tax liability for each Donor less than the amount of unified credit against gift tax to which the Donor is entitled at this time under applicable provisions of law.

2. *Future Adjustment.* Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share of capital stock of the Corporation exceeds or is less

than $2,000.00 an adjustment will be made in the number of shares constituting each gift so that each Donor will give to each Donee the maximum number of full shares of capital stock of the Corporation, the total value of which will be $50,000.00 from each Donor to each Donee and a total of $150,000 from each Donor to all Donees. Any adjustment so made which results in an increase or decrease in the number of shares held by a stockholder of the Corporation will be made effective as of the same date as this Agreement, and any dividends paid thereafter shall be recomputed and reimbursed as necessary to give effect to the intent of this Agreement.

On December 31, 1980, each petitioner made a gift of 4 shares of stock in J-Seven to each son, and on January 15, 1981, each petitioner made a gift of 5 additional shares to each son. At both times, the petitioners and their sons executed an agreement identical to the gift adjustment agreement of December 1979, with the exception that the acknowledged value of the gifted shares differed: the December 1980 agreement recited a value per share of $2,300 and a value per gift of 4 shares of $9,200; the January 1981 agreement recited a value per share of $2,300 and a value per gift of 5 shares of $11,500.

As of December 31 of each year, the outstanding shares of J-Seven stock were owned as follows:

	1978	*1979*	*1980*	*1981*
Charles W. Ward	437	362	350	335
Virginia P. Ward	437	362	350	335
Charles Jr.	42	92	100	110
William	42	92	100	110
John	42	92	100	110

Each share of stock outstanding was entitled to one vote and to dividends when and as declared by the corporation's board of directors. During the years in issue, all five stockholders were directors of the corporation, and the corporate officers were Mr. Ward (president), Mrs. Ward (secretary-treasurer), and Charles, Jr. (vice president).

J-Seven is a "cow and calf" ranch business; the cows owned by the corporation are bred to bulls, and all resulting calves are sold within the year unless retained to replace lost or sold breeding stock. All 1,200 of the cattle contributed to J-Seven upon incorporation were breeding cows, and J-Seven owned 1,200 breeding cows throughout the years in issue. A breeding cow is kept, often for 10 or more years, to produce calves, whereas a beef cow is raised for slaughter. The breeding cows owned by J-Seven were cross-bred (i.e., not purebred) and of inferior quality, being classified as Florida range or scrub cows. Few cattlemen would purchase such cows for breeding purposes because they prefer more highly bred cows; if sold for slaughter (beef) purposes, such cows would be classed as "canner or low-cutter" grade, rather than as the higher grades (from highest to lowest) of "choice," "good," "commercial," "utility," and "cutter." The J-Seven cows weighed from 600 to 700 pounds each and had a breeding percentage of 50 percent,[2] which was below the Florida average of 85 percent.

During 1979 through 1981, J-Seven was an electing small business corporation for Federal income tax purposes. The corporation reported net income (after depreciation) of $24,507 in 1979, $14,126 in 1980, and $10,723.89 in 1981. In 1980 and 1981, J-Seven paid Charles, Jr., and William $15,000 each as compensation for operating the ranch, and such amounts were deducted in computing the corporation's net profit. In 1981, D & W Farms paid Mr. and Mrs. Ward $9,000 to rent a parcel of the land owned by J-Seven; Mr. and Mrs. Ward reported the rent as income on their individual tax return for 1981, but the corporation did not report such rent as income.

Aside from their ownership of J-Seven, the petitioners and their sons are persons of modest means. From 1976 through 1983, the petitioners' adjusted gross income, as reported on their joint income tax returns, did not exceed $32,110 in any year; and from 1978 through 1983, each son's adjusted gross income, as reported on his income tax return, did not exceed $30,155 in any year.[3]

On their gift tax returns for 1978, each petitioner reported making a gift of an undivided one-half interest in each of the three parcels of land conveyed to their sons and their wives in October 1978. Mr. Ward valued each of his three reported gifts at $2,000, and Mrs. Ward valued each of her three reported gifts at $2,000. Each petitioner signed the gift tax return of the other, consenting to have gifts made by either spouse to third parties treated as made one-half by each of them (i.e., electing split-gift treatment). On their gift tax returns for 1979 through 1981, each petitioner reported the gifts to the sons of J-Seven stock as follows:

---

[2] The "breeding percentage" of a cow refers to the likelihood of its calving in each year. Thus, if a herd of cows has a breeding percentage of 50 percent, then, in each year, 1 calf is born for every 2 cows, or 600 calves for every 1,200 cows.

[3] Charles, Jr., and William each filed a joint Federal income tax return with his wife. John filed as a single individual.

Year of gifts	*Total shares transferred*	*Fair market value per share as reported*	*Total value as reported*
1979	75	$2,000	$150,000
1980	12	2,300	27,600
1981	15	2,300	34,500

The Commissioner issued separate notices of deficiency to the petitioners. The Commissioner determined that Mr. Ward made a gift to Mrs. Ward of the 437 shares of J-Seven stock that she received upon the incorporation of the ranch. He valued such gift as follows:

Value of assets transferred to J-Seven:		
Land (5,608 acres) value on 12/31/78		$2,385,000
Depreciable assets		132,233
Cattle — 1,200 head at $500 per head		600,000
Total value of 1,000 shares		3,117,233
Per share value	$3,117	
	×437 shares	
Value of gift	$1,362,129	

The Commissioner also determined the fair market value of the J-Seven stock and, thus, the total amounts of each petitioner's gifts of stock in 1979 through 1981 to be as follows:

Year of gifts	*Fair market value per share as determined*	*Total gifts of each petitioner as determined*
1979	$3,700	$277,500
1980	4,275	51,300
1981	4,287	64,305

The Commissioner computed the total value of each petitioner's gifts in the following manner:

	12/31/79	*12/31/80*	*3/31/81*
Value of assets of J-Seven:			
Land (5,608 acres)	$2,945,000	$3,505,000	$3,505,000
Cash	19,475	29,557	38,257

	12/31/79	*12/31/80*	*3/31/81*
Depreciable assets	$137,265	$141,309	$143,431
Cattle (1,200 head at $500 per head)	600,000	600,000	600;000
Total value of 1,000 shares	3,701,740	4,275,866	4,286,688
Per-share value	3,700	4,275	4,287
Total shares given	×75	×12	×15
Total value of gifts	277,500	51,300	64,305

By amendment of his answer, the Commissioner further determined that: (1) Mr. Ward, alone, made gifts of land to his sons and their wives in 1978; (2) Mr. Ward gave 8.9 acres to Charles, Jr., and his wife, 10 acres to William and his wife, and 85 acres to John; and (3) the per-acre value of such land was $425 at the time of the gifts.

The parties now agree that J-Seven owned the following amounts of cash and that its land and depreciable assets had the following fair market values when the gifts (or alleged gift) of stock were made:

	1978	*1979*	*1980*	*1981*
Land	$425/acre	$500/acre	$525/acre	$525/acre
Cash	0	19,475	29,557	38,257
Depreciable assets	132,233	137,265	141,309	143,431

The parties further agree that J-Seven purchased an unknown quantity of additional land for $12,000 on May 7, 1980.

OPINION

The first issue for decision is whether Mr. Ward made a gift to his wife of 437 shares of stock in J-Seven when the ranch was contributed to J-Seven, and Mr. and Mrs. Ward each received 437 shares of the corporation in exchange. The resolution of such issue turns on whether Mrs. Ward had an ownership interest in the ranch despite the fact that Mr. Ward, alone, held legal title to the property. The petitioners contend that Mrs. Ward was the beneficial owner of an undivided one-half interest in the ranch by virtue of either a resulting trust, a constructive trust, or a special equity, in her favor.

The ranch was located in Florida, and the law of that State is applicable in determining what interest, if any, Mrs. Ward may have had in the property. *United States v. National Bank of Commerce*, 472 U.S. ____ (1985); *Morgan v. Commissioner*, 309 U.S. 78 (1940). In making this determination, we are, "in effect, sitting as a state court," being bound by decisions of the Supreme Court of Florida and "giving 'proper regard' to relevant rulings of other courts of the State." *Commissioner v. Estate of Bosch*, 387 U.S. 456, 465 (1967); *Estate of Fulmer v. Commissioner*, 83 T.C. 302, 306 (1984).

Resulting and constructive trusts are implied, as opposed to express, trusts. *Wadlington v. Edwards*, 92 So. 2d 629, 631 (Fla. 1957). A resulting trust arises automatically where property is transferred to one person and the purchase price is paid by another. Under such circumstances, the grantee is presumed to hold title on a resulting trust for the person who furnished the consideration. *Towerhouse Condominium, Inc. v. Millman*, 475 So. 2d 674, 677 (Fla. 1985); *State Dept. of Revenue v. Zuckerman-Vernon Corp.*, 354 So. 2d 353, 356 (Fla. 1977); *Smith v. Smith*, 143 Fla. 159, 196 So. 409, 410 (1940); 5 A. Scott, Trusts 3213, 3309 (3d ed. 1967). A constructive trust is imposed where a person holding title to property would be unjustly enriched if he were permitted to retain it. *Wadlington v. Edwards*, 92 So.2d at 631; *Tillman v. Pitt Cole Co.*, 82 So. 2d 672, 674 (Fla. 1955). The person holding title may be subject to an equitable duty to convey the property to another where the property was acquired "through fraud, duress, undue influence or mistake, or through breach of a fiduciary duty, or through the wrongful disposition of another's property." 5 A. Scott, *supra* at 3215; see *Wadlington v. Edwards*, *supra*; *Tillman v. Pitt Cole Co.*, *supra*; *Socarras v. Yaque*, 452 So. 2d 992, 994 (Fla. Dist. Ct. App. 1984). Whereas a resulting trust arises because the circumstances support the inference that a trust was actually intended, a constructive trust is imposed without regard to the intention of the parties. *Palmland Villas I Condominium Association, Inc. v. Taylor*, 390 So. 2d 123, 125 (Fla. Dist. Ct. App. 1980). Indeed, in a constructive trust, "The element of intent or agreement either oral or written to create the trust relationship is totally lacking." *Wadlington v. Edwards*, 92 So. 2d at 631.

Florida places the burden of proving a resulting trust or a constructive trust on the party who seeks its enforcement, and the proof of either must be "clear and convincing." *King v. King*, 111 So. 2d 33 (Fla. 1959); *Steinhardt v. Steinhardt*, 445 So. 2d 352 (Fla. Dist. Ct. App. 1984); *Hiestand v. Geier*, 396 So. 2d 744 (Fla. Dist. Ct. App. 1981). In the present case, we find that the petitioners have clearly and convincingly[4] established that Mrs. Ward was the beneficial owner of an undivided one-half interest in the ranch by virtue of a resulting trust.

The circumstances surrounding the purchase of the ranch clearly indicate that Mr. and Mrs. Ward intended that Mr. Ward hold legal title to the property for the benefit of them both. At the time they married, the petitioners had no assets other than some cattle owned by Mr. Ward. The ranch was their first real estate purchase. Although Mr. Ward paid the downpayment to FLT, the subsequent installment payments due FLT and the purchase money paid to the Ryan sisters were drawn from the petitioners' joint bank account to which Mrs. Ward made material contributions. She was employed by her father for substantially the entire period during which the installments were due (February 1942 to February 1944), and she deposited her pay to the joint account. It is true that the petitioners kept no record of their respective deposits to the joint account, and it is also true that, 40 years later, Mrs. Ward cannot remember exactly how much money she earned, although she does recall that her father paid her quite well because of the long and unusual hours she worked, their family relationship, and his knowledge of the petitioners' financial needs. The special deed to Mrs. Ward, prepared by Mr. Ward during the course of the purchase of the ranch, furnishes additional evidence of their intention that the jointly purchased property was owned by them in equal shares.[5] The deed was prepared contemporaneously, and although it may not have been delivered, we have no reason to believe that the failure to do so was due to any disagreement over its provisions.

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[4] On brief, the petitioners objected to the imposition of a higher standard of proof than the standard generally applicable in this Court, a preponderance of the evidence. See *Valetti v. Commissioner*, 260 F.2d 185, 187 (3d Cir. 1958), revg. on other grounds 28 T.C. 692 (1957). In an unpublished Memorandum Opinion, we have held that the fact that we look to State law to determine ownership interests in property does not mean that we are to apply the State's test of the sufficiency of the evidence of such ownership interests (*Estate of Levine v. Commissioner*, T.C. Memo. 1968-54); but in other cases, we have looked to State law for the measure of proof required to establish an ownership interest in property, and we have applied the State test even if demanding proof by more than a preponderance of the evidence (see, e.g., *Crane v. Commissioner*, 49 T.C. 85, 92-93 (1967); *Estate of Holt v. Commissioner*, 14 B.T.A. 564, 569 (1928); *Estate of Bloise v. Commissioner*, T.C. Memo. 1966-44; *Estate of Bourland v. Commissioner*, T.C. Memo. 1958-92; cf. *Berger v. United States*, 487 F. Supp. 49, 51 (W.D. Pa. 1980)). We need not decide whether Florida's higher standard of proof *must* be applied in this case (as the Commissioner contends) because we are persuaded that the petitioners have, in fact, met such standard. See *Dodge v. United States*, 413 F.2d 1239, 1242 n.5 (5th Cir. 1969).

The Commissioner disputes that the petitioners intended to own the ranch jointly. He argues that Mr. Ward bought the land so that he and his brother, David Elmer Ward, would have a place to run their cattle. The Commissioner points out that the land contract with FLT provided that FLT was to deliver a deed into escrow that named Mr. Ward and David Elmer Ward as co-grantees.

Mr. Ward originally requested that David Elmer Ward be a co-grantee of the escrow deed because his brother then was thinking of joining in the purchase, but his brother was not a party to the land contract. Mr. Ward supplied the downpayment, and only he was contractually obligated to purchase the property. As it turned out, David Elmer Ward purchased other land shortly thereafter, and he never made any contributions toward the purchase from FLT. Instead, Mr. and Mrs. Ward paid the installments due FLT. In light of all the circumstances, these subsequent joint contributions support the inference that Mr. and Mrs. Ward then intended that Mr. Ward take legal title for their mutual benefit upon fulfillment of the contract. In this connection we observe that a resulting trust arises, if at all, "at the instant the deed is taken and the legal title vests in the grantee"; the alleged beneficiary "must have paid his share of the purchase price, or bound himself to the grantor by an absolute obligation to pay it. No oral agreement, and no payments made after the title is taken, will create resulting trust." *Womack v. Madison Drug Co.*, 155 Fla. 335, 20 So. 2d 256, 257 (1944); see *Socarras v. Yaque*, 452 So. 2d at 994; *Harnish v. Peele*, 386 So. 2d 8, 10 (Fla. Dist. Ct. App. 1980). Mrs. Ward paid a share of the purchase price before legal title vested in Mr. Ward. Under the doctrine of equitable conversion, he became the equitable, or beneficial, owner of the property immediately upon entering into the land contract with FLT, but his interest in the property did not indefeasibly vest until he paid the last installment due under the contract; only then could he compel FLT to convey legal title. *Henry v. Ecker*, 415 So. 2d 137 (Fla. Dist. Ct. App. 1982); see *Hull v. Maryland Casualty Co.*, 79 So. 2d 517 (Fla. 1954); *Lazer, N.V. v. Hollo*, 432 So. 2d 102 (Fla. Dist. Ct. App. 1983); *B.W.B. Corp. v. Muscare*, 349 So. 2d 183 (Fla. Dist. Ct. App. 1977).

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[5] The Commissioner questions the reliability of the special deed because it is dated Mar. 2 1943, and recites that the deeds from the Ryan sisters and FLT "should have been made a executed to both" Mr. and Mrs. Ward, when, in fact, FLT did not deliver a deed until M 1944. (The Ryan sisters executed their deed in October 1942.) We think the appare discrepancy is easily explained. The special deed was prepared on the basis of the la contract with FLT, which provided that FLT was to deliver a deed to Mr. Ward as so grantee upon fulfillment of the contract. (The escrow deed to Mr. Ward and David Elm Ward, as co-grantees, was never delivered.)

"It is well settled today that a resulting trust may arise when only a part of the purchase price has been paid by one person and title is taken in the name of another." 5 A. Scott, *supra* at 3369. In Florida, payment of part of the consideration carries with it a proportional interest in the property, and the person taking title to the whole becomes the trustee for the other person, pro tanto. *Towerhouse Condominium, Inc. v. Millman*, 475 So. 2d at 677; *Johnson v. Craig*, 158 Fla. 254, 28 So. 2d 696, 698-699 (1947); *Hiestand v. Geier*, *supra*. However, it is impossible in the present case to determine the part of the consideration for the ranch that Mrs. Ward supplied. The rule in Florida is unclear where a person has made an indeterminate contribution toward the purchase price.

In *Rosenthal v. Largo Land Co.*, 146 Fla. 81, 200 So. 233, 237 (1941), the court stated:

> The law is established to the effect that a person claiming a resulting trust must show that he paid *some specific sum*, for *some distinct interest in, or aliquot part of the said land*: for example, one-half or one-quarter, or other particular fraction of the whole; or for a particular interest as an estate for life or for years or remainder in the whole estate. [Emphasis added.]

Since *Rosenthal v. Largo Land Co.* was decided, the latter requirement that the contributor pay for an aliquot part of the land has been eliminated; the contributor of a determinate sum now takes a proportionate share. *Towerhouse*

Condominium, Inc. v. *Millman*, *supra*; *Johnson* v. *Craig*, *supra*. But what of the requirement that the contributor have paid "some specific sum"?

> It is often said that a resulting trust does not arise in favor of one who merely makes a "general" or "indefinite" contribution to the purchase price. If A has made contributions from time to time to a fund to which B also contributes, and no account is kept as to the contributions made by each, and the whole fund is used by B in purchasing property, it is held that no resulting trust arises. * * * If there is no evidence as to the amounts contributed it is, of course, impossible to prove what shares the contributors are entitled to. In a few cases the court has cut the knot by holding that where the amounts contributed cannot be ascertained the contributors are entitled to the property in equal shares. At any rate, the indefinite character of A's contributions tends to show that it was not the understanding of the parties that he was to receive any interest in the property purchased. * * * The presumption of a gift or loan arising from the indefinite character of the contributions should be a rebuttable presumption. [5 A. Scott, *supra* at 3374-3376; fn. refs. omitted.]

However, equity may loosen the proof required to establish a resulting trust where the contributors are husband and wife:

> In the case of a purchase of a matrimonial home the usual rules as to a resulting trust are much relaxed. This is especially the case where the spouses are of quite moderate means, and are not likely to make any written or even oral agreement as to the beneficial ownership of the home, and where both have small savings or both are employed, and both contribute to the family support.
>
> It is often a purely accidental circumstance whether money of the husband or of the wife is actually used to pay the purchase price to the vendor, where both are contributing by money or labor to the various expenses of the household. It is often a matter of chance whether the family expenses are incurred and discharged or services are rendered in the maintenance of the home before or after the purchase.
>
> Although many of the cases involve the purchase of the matrimonial home, similar considerations are applicable to the purchase of other land or even to the purchase of personal property during the period of the marriage.
>
> The title may be taken in the name of the husband alone, or in the name of the wife alone, or in their joint names; and the reason for doing so may have nothing to do with the question of who is to have the beneficial interest, a question which later becomes important when one of them dies, or they separate or are divorced.
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> [5 A. Scott, Trusts 31-32 (Supp. 1985); fn. ref. omitted.]

Were the highest court of Florida now confronted with the question, we are convinced that the court would relax the standards for a resulting trust if the contributors were married. We are persuaded thus by that court's recognition, in similar factual circumstances, of a "special equity" in divorce settlements.

A "special equity" appears to be the functional equivalent of a resulting trust in marriage dissolution cases. A special equity is "a vested interest in property brought into the marriage or acquired during the marriage because of contribution of services or funds over and above normal marital duties." *Canakaris v. Canakaris*, 382 So. 2d 1197, 1200 (Fla. 1980); see *Bosch v. United States*, 590 F.2d 165, 167 (5th Cir. 1979); *Mann v. Commissioner*, 74 T.C. 1249, 1259 (1980). Although the special equity "only comes into actual identifiable form upon the termination of the marriage status" (*Bosch v. United States*, 590 F.2d at 167), it is not alimony (*Canakaris v. Canakaris, supra*; *Duncan v. Duncan*, 379 So. 2d 949, 952 (Fla. 1980); *Heath v. Heath*, 103 Fla. 1071, 138 So. 796 (1932)). The special equity concept developed in case law because Florida's former alimony statute absolutely denied alimony to an adulterous wife. *Heath v. Heath, supra.* A court will award a special equity in separately held property only on proof that the spouse without title has made an "extraordinary contribution toward its acquisition, either financially or through personal industry and service to the other party." *Ball v. Ball*, 335 So. 2d 5, 7 (Fla. 1976); see *Eakin v. Eakin*, 99 So. 2d 854 (Fla. 1958); *Strauss v. Strauss*, 148 Fla. 23, 3 So. 2d 727 (1941). For example, a special equity may arise when a wife's capital or labor nurtures the husband's separately owned business. *Engebretsen v. Engebretsen*, 151 Fla. 372, 11 So. 2d 322 (1942); *Heath v. Heath, supra*; *Beugnet v. Beugnet*, 383 So. 2d 1186 (Fla. Dist. Ct. App. 1980); see *Bosch v. United States, supra*; *Mann v. Commissioner, supra.* Often, if the amount of their respective contributions cannot be definitely established, the wife has been awarded a one-half interest in property held in the husband's name where the wife's services materially assisted the accumulation of the property or the husband acquired the property with funds drawn from a joint bank account to which both

substantially contributed. See, e.g., *Beugnet v. Beugnet*, *supra*; *Knoblock v. Knoblock*, 351 So. 2d 387 (Fla. Dist. Ct. App. 1977); *Scheidl v. Scheidl*, 343 So. 2d 963 (Fla. Dist. Ct. App. 1977); *Razzano v. Razzano*, 307 So. 2d 894 (Fla. Dist. Ct. App. 1975); *Green v. Green*, 228 So. 2d 112 (Fla. Dist. Ct. App. 1969).

In the case before us, we are convinced that Mr. and Mrs. Ward contributed jointly toward the purchase of the ranch with the intent and understanding that they would own the ranch jointly. That Mrs. Ward cannot now establish the exact amount of her financial contribution does not negate the inference of a resulting trust from the circumstances surrounding the purchase. Accordingly, we hold that Mrs. Ward was the owner of an undivided one-half interest in the ranch before it was conveyed to J-Seven and, therefore, that Mr. Ward made no gift to her when she received 437 shares upon its contribution to J-Seven.

The next issue for decision is the number of acres of land given by the petitioners to their son, John, and to their son, Charles, Jr., and his wife, Frenda, in 1978. The Commissioner maintains that John received 85 acres and that Charles, Jr., and Frenda received 8.9 acres. The Commissioner bears the burden of proof on this issue, having raised it for the first time by amendment of his answer. Rule 142(a), Tax Court Rules of Practice and Procedure.[6] The record clearly establishes that the petitioners intended to give each of their sons (with their wives) a 10-acre parcel of the ranch. On their gift tax returns for 1978, each petitioner reported making a gift of an undivided one-half interest in each of the three described parcels. The one-half interests were valued equally at $2,000, for a total fair market value of $4,000 per 10 acre parcel ($400 per acre).

Reading the description of the land conveyed to John, the Commissioner has come to the understandable, but nonetheless incorrect, conclusion that John received 85 rather than 10 acres of land. The parcel was described as follows:

> The south one-half (S 1/2) of the northwest quarter (NW 1/4) and the north one-half (N 1/2) of the southeast quarter (SE 1/4) of the northwest quarter (NW 1/4) of the southwest quarter (SW 1/4) of Section 28, Township 46 South, Range 33 East[.]

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[6] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

As we read such description, all of the statements following "the north one-half (N 1/2) of the southeast quarter (SE 1/4)" pertain to both the "south one-half" and the "north one-half" previously described. Thus, John received the south one-half of the northwest quarter and the north one-half of the southeast quarter, where both such half-quarters are located in the northwest quarter of the southwest quarter of section 28. Since a section contains 640 acres, one-half of a quarter, of a quarter, of a quarter, of a section contains 5 acres, and two such halves contain a total of 10 acres. To find that the parcel described contains 85 acres, one would have to read the description as conveying the south one-half of the northwest quarter of section 28 (or one-half of 160 acres, or 80 acres) plus the north one-half of the southeast quarter of the northwest quarter of the southwest quarter of section 28 (or 5 acres). Such reading would require that commas be inserted so that the description would read:

> The south one-half (S 1/2) of the northwest quarter (NW 1/4), and the north one-half (N 1/2) of the southeast quarter (SE 1/4) of the northwest quarter (NW 1/4) of the southwest quarter (SW 1/4), of Section 28, Township 46 South, Range 33 East.

Although there may be some ambiguity in the description as written, its meaning becomes clear when considered in the light of the petitioners' and John's understanding that he was to receive 10 acres.

There was some testimony to the effect that the Hendry County tax assessor's office interpreted the deed to John as conveying 85 acres of land. If so, the assessor's office labors under the same misinterpretation as does the Commissioner, but such mistake does not alter the legal effect of the deed, which was to convey only 10 acres.

We turn now to the gift of land to Charles, Jr., and Frenda: it is indisputable that the parcel described contained 8.9 rather than 10 acres of land. That they received less than 10 acres was due to a mistake either in drafting or calculation. The petitioners ask that we find that they made a gift of 10 acres because, under Florida law, the parties can voluntarily execute a corrected deed or the petitioners could obtain a judicial reformation of the deed. However, "not even judicial reformation can operate to change the federal tax consequences of a completed transaction." *Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 (7th Cir. 1968); see *Harris v. Commissioner*, 461 F.2d 554, 556 n. 2 (5th Cir. 1972), affg. a Memorandum Opinion of this Court; *Emerson Institute v. United States*, 356 F.2d 824 (D.C. Cir. 1966); *Piel v. Commissioner*, 340 F.2d 887 (2d Cir. 1965), affg. a Memorandum Opinion of this Court; *M.T. Straight's Trust v. Commissioner*, 245 F.2d 327 (8th Cir. 1957), affg. 24 T.C. 69 (1955); *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946); contra *Flitcroft v. Commissioner*, 328 F.2d 449 (9th Cir. 1964), revg. 39 T. C. 52 (1962). The petitioners made a completed gift of 8.9 acres in 1978, and until they execute a corrected deed or obtain a judicial reformation, they have not made a completed gift of the additional 1.1 acres that they intended to convey to Charles, Jr., and Frenda. For their part, Charles, Jr., and Frenda have no power to compel the petitioners to convey the additional acreage. Under Florida law, the grantee of a voluntary conveyance, made without any consideration, cannot obtain reformation as against the grantor: "There being no consideration moving the grantor, the volunteer has no claim on him. If there is a mistake or a defect, it is a mere failure in a bounty which, as the grantor was not bound to make, he is not bound to perfect." *Smith v. Pattishall*, 127 Fla. 474, 176 So. 568, 575 (1937), quoting 23 R.C.L. 344, 345; see also *Triesback v. Tyler*, 62 Fla. 580, 56 So. 947 (1911); *Kelly v. Threlkeld*, 193 So. 2d 7 (Fla. Dist. Ct. App. 1966); *Harrod v. Simmons*, 143 So. 2d 717 (Fla. Dist. Ct. App. 1962).

Accordingly, we conclude that the petitioners together made gifts of 10 acres to John, 10 acres to William and his wife, Barbara, and 8.9 acres to Charles, Jr., and Frenda. The parties now agree that the land had a fair market value of $425 per acre in 1978 rather than the $400 per acre reported on the petitioners' gift tax returns.

The third issue for decision is the value of the shares of J-Seven stock given by the petitioners to their sons in 1979, 1980, and 1981. The gift tax is imposed "on the transfer of property by gift." Sec. 2501(a)(1). The gift is measured by the value of the property passing from the donor; if the gift is made in property, the property's value at the date of the gift is considered the amount of the gift. Sec. 2512(a); secs. 25.2511-2(a) and 25.2512-1, Gift Tax Regs. Section 25.2512-1 of the regulations states that "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."

In determining the value of unlisted stocks, actual arm's-length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value. *Duncan Industries, Inc. v. Commissioner*, 73 T.C. 266, 276 (1979). However, the stock of J-Seven has never been publicly traded, and there have never been any sales of the stock. In the absence of arm's-length sales, the value of the stock is to be determined by taking into consideration the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors. Sec. 25.2512-2(f), Gift Tax Regs.; *Estate of Andrews v. Commissioner*, 79 T.C. 938, 940 (1982). Such "other relevant factors" include:

> the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of the control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. [Sec. 25.2512-2(f), Gift Tax Regs.]

The petitioners contend that the valuation of the J-Seven stock should be based, in part, on the liquidation value of the corporation's assets and the value placed on the shares in the stockholders' stock purchase agreement, but that greater weight should be given the corporation's earnings and dividend-paying capacity. The Commissioner maintains that the stock valuation should be based solely on the value of the corporation's assets, without any reduction for liquidation costs (i.e., real estate sales commissions and income taxes due on the sale) and without any discounts for lack of control or lack of marketability.

Both parties' expert witnesses valued the stock of J-Seven by reference to the value of the corporation's underlying assets alone. Both experts reviewed the corporation's income tax returns and, based on the information contained therein, concluded that the stock could not be valued properly using an income capitalization method because the corporation's return on its admittedly valuable assets was exceedingly low. In the words of the petitioners' expert, an income capitalization approach would place a "ridiculous[ly] low" value on the stock. The experts agreed that the corporation's value lay in its assets, not in its earning power as an operating ranch.

Where there is an ongoing business such as we have in this case, courts generally have refused to treat either asset value or earnings power as the *sole* criterion in determining stock value. See *Hamm v. Commissioner*, 325 F.2d 934, 941 (8th Cir. 1963), affg. a Memorandum Opinion of this Court; *Estate of Andrews v. Commissioner*, 79 T.C. at 945; *Portland Manufacturing Co. v. Commissioner*, 56 T.C. 58, 80 (1971), affd. without published opinion (9th Cir., April 21, 1975); *Trianon Hotel Co. v. Commissioner*, 30 T.C. 156, 181 (1958); *Hooper v. Commissioner*, 41 B.T.A. 114, 129 (1940). In the cases in which stock was valued solely on the basis of asset value, the corporations were, in essence, in the business of selling their assets, and thus, earnings were not a reliable indicator of value. *Harwood v. Commissioner*, 82 T.C. 239 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986) (timber business); *Estate of Huntington v. Commissioner*, 36 B.T.A. 698 (1937) (real estate subdivision and sales). However, the degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to earnings power as opposed to net asset value. *Estate of Andrews v. Commissioner*, 79 T.C. at 945.

The petitioners and their sons were actively involved in the ranching business long before J-Seven was incorporated. Neither they nor the corporation has engaged in the business of selling the ranch's underlying assets. In fact, the corporation was formed because the petitioners wanted to pass the cattle business on to their sons, intact. There is no evidence that the corporation intended to liquidate, and there was no power to liquidate attendant to the minority interests given to the sons during the years in issue. Under these circumstances, the earnings power of the corporation is a factor to be considered in valuing the stock given to the sons. However, in light of the tremendous disparity between the corporation's value as an operating company and its value as an investment holding company, we think such factor is adequately taken into account by reducing the stock's value, as determined under a net asset value method, by a minority discount. A minority discount reflects the minority shareholder's inability to compel a liquidation and, thus, to receive a pro rata share of the corporation's net asset value. *Harwood v. Commissioner*, 82 T.C. at 267.

The only corporate assets the value of which are in dispute are the 1,200 breeding cows owned by the corporation on the date of each gift of stock. The Commissioner determined that each cow had a value of $500 on the date of each gift. He argues that the cows must be valued at the price they would fetch if sold for breeding purposes. The cows were mixed-breed, low-quality, Florida range cattle. We are persuaded that such cows, while usable for breeding, could not be sold for such purpose because of their inferior quality. Charles, Jr., testified that the sales prices reported in the "Florida Livestock Market Report" (published weekly by the Florida Department of Agricultural and Consumer Services) for slaughter cows rated "canner and low-cutter" were consistent with, if not a little higher than, the amount J-Seven received when it sold its breeding cows. According to the "Florida Livestock Market Report," cows of such quality sold for 35 to 44 cents per pound in mid-December 1979, 30 to 38 cents per pound in early December 1980, and 30 to 37 cents per pound in mid-January 1981. Based on an average weight of 650 pounds per cow, we find that the 1,200 J-Seven cows had a fair market value of $260 each in December 1979 and $221 each in December 1980 and January 1981.

The petitioners contend that, in arriving at the corporation's net asset value, adjustments should be made to reflect costs that would be incurred if its assets were liquidated. They seek adjustments for the expenses of selling the real estate (including sales commission) and the income taxes that would be recognized by the corporation or its shareholders upon liquidation. We disagree with this argument. J-Seven is not in the business of selling its assets piecemeal, and as the petitioners themselves have argued, there is no evidence that the liquidation of the entire corporation is imminent or even contemplated. Under such circumstances, "We need not assume that conversion into cash is the only use available to an owner, for property which we know would cost him market value to replace." *Estate of Cruikshank v. Commissioner*, 9 T.C. 162, 165 (1947). A hypothetical willing buyer of the shares in an arm's-length sale could expect no reduction in price for sales expenses and taxes that he might incur in a subsequent sale of either the shares or the corporation's underlying assets. When liquidation is only speculative, such costs are not to be taken into account. *Estate of Andrews v. Commissioner*, 79 T.C. at 942; *Estate of Piper v. Commissioner*, 72 T.C. 1062, 1086-1087 (1979); *Estate of Cruikshank v. Commissioner, supra.*[7]

Since the parties now agree on the fair market value of the land, the cash, and the depreciable assets owned by J-Seven, and since we have now found the values of the cows, we find that J-Seven had a net asset value (the corporation had no liabilities) and a net asset value per share on the dates of the gifts, as follows:

Date of gift	*Net asset value*	*Net asset value per share*
Dec. 28, 1979	$3,310,290	$3,310
Dec. 31, 1980	3,431,693	3,432
Jan. 15, 1981	3,442,515	3,443

However, this finding does not end the matter because we must still determine whether the stock purchase agreement affected the value of the shares and what, if any, discounts for lack of control and lack of marketability are applicable.

The petitioners urge that the fair market value of the J-Seven stock was depressed by the existence of the stock purchase agreement. They do not maintain that the value of the stock was limited to $2,000 a share, the price set forth in the certificate of value executed on March 10, 1979, and they offer no evidence to demonstrate how much the value of the stock was affected by the stock purchase agreement. The Commissioner argues that the fair market value of the stock was not reduced at all by the stock purchase agreement.

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[7] The petitioners rely on *Estate of Dooly v. Commissioner*, T.C. Memo. 1972-164, wherein we stated: "The value ultimately selected by him [the taxpayers' stock valuation expert] was somewhat higher than the figures resulting from the earnings and dividend approaches and somewhat lower than that based upon asset value, and much of the reduction from asset value is properly accountable by the appropriate discounts for a minority interest and for liquidation." However, there is no indication that the Commissioner challenged the propriety of the allowance for liquidation costs in that case.

A stockholder agreement granting fellow stockholders and the corporation a right of first refusal in any lifetime sale of shares and requiring that the corporation repurchase the shares at death, at a price fixed in the agreement, is not determinative of the fair market value of the shares for gift tax purposes. *Spitzer v. Commissioner*, 153 F.2d 967 (8th Cir. 1946), affg. a Memorandum Opinion of this Court; *Berzon v. Commissioner*, 63 T.C. 601 (1975), affd. 534 F.2d 528 (2d Cir. 1976); *James v. Commissioner*, 3 T.C. 1260 (1944), affd. 148 F.2d 236 (2d Cir. 1945). Such an agreement is, at most, a factor to be considered with all other relevant factors in determining value. *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970).

Upon examination of the terms of the J-Seven stock purchase agreement, we hold that its restrictions depressed the value of the shares only minimally. The restrictions had little, if any, effect on the value of the shares because the price fixed in the certificate of value was effective for only 2 years. Thereafter, the parties would have to agree to a new price or have the stock independently appraised, either of which would likely result in a price approximating the stock's current fair market value. Although the price was fixed at $2,000 when the petitioners made the gifts of shares to their sons, there was no indication that the sons intended to sell the shares before the $2,000 price lapsed in March 1981. Moreover, even at the times of the gifts, the stock might have been sold for more than $2,000 a share if the other stockholders and the corporation were unable to purchase stock offered to them under the stock purchase agreement. However, because the stock could not be given away without the written consent of the other stockholders, and because the shares would remain subject to the restrictions in the hands of any donee or purchaser, the value of the stock was depressed to some small extent, and accordingly, some allowance will be made for such effect.

The shares given by the petitioners to each of their sons represented minority interests in the corporation. Relying on the testimony and report of their expert, the petitioners contend that the value of the shares must be discounted by 33⅓ percent to reflect lack of control over the corporation (a minority discount) and lack of marketability. The Commissioner contends that no minority discount or lack of marketability discount is warranted where family members control a corportion, as in the present case. He argues that the shares represented an interest in pooled " 'family assets,' rather than an interest in a viable corporation where control and marketability are key elements. Further, under these circumstances, the possibility of transfer of the business to nonfamily members was extremely remote. There was clearly a ready market for an individual's shares either in the corporation or in the shareholders."

The courts have long recognized that the shares of stock of a corporation which represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (en banc); *Harwood v. Commissioner*, *supra*; *Estate of Andrews v. Commissioner*, *supra*; *Estate of Zaiger v. Commissioner*, 64 T.C. 927 (1975); *Estate of deGuebriant v. Commissioner*, 14 T.C. 611 (1950), revd. on other grounds sub nom. *Claflin v. Commissioner*, 186 F.2d 307 (2d Cir. 1951); *Hooper v. Commissioner*, *supra*; *Sundquist v. United States*, an unreported case (E.D. Wash. 1974, 34 AFTR 2d 74-6337, 74-2 USTC par. 13,035); *Obermer v. United States*, 238 F. Supp. 29 (D. Hawaii 1964); *Drybrough v. United States*, 208 F. Supp. 279 (W.D. Ky. 1962). The minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel a liquidation of corporate assets. See *Harwood v. Commissioner*, 82 T.C. at 267; *Estate of Andrews v. Commissioner*, 79 T.C. at 953; *Drybrough v. United States*, 208 F. Supp. at 287-288.[8] A lack of marketability discount, on the other hand, reflects the fact that there is no ready market for shares in a closely held corporation. *Estate of Andrews v. Commissioner*, 79 T.C. at 953.

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[8] *Carr v. Commissioner*, T.C. Memo. 1985-19; *Estate of Kirkpatrick v. Commissioner*, T.C. Memo. 1975-344.

In *Estate of Bright v. United States, supra*, the Fifth Circuit, sitting en banc, rejected the Government's argument that shares being valued should be combined with other shares owned by the taxpayer's spouse or family in determining whether a control premium or minority discount is warranted. *Estate of Bright* involved the value for estate tax purposes of the decedent's interest in community property, a 55-percent stock interest in three closely held corporations. The decedent's interest was devised to a trust, over which her husband was trustee, for the primary benefit of her children. The Government contended that because the interest to be valued was an undivided one-half interest in the full 55-percent control block, the proper method of valuing such interest would be to value the whole, including its control premium, and then take one-half thereof as the value of the estate's interest. The Fifth Circuit rejected the Government's approach on the ground that the community property was subject to partition and that, consequently, the estate's interest was equivalent to a 27½ percent block of stock. The court refused to attribute any control premium to the estate's interest, even though the decedent's husband, as owner of a 27½ percent block and as trustee of the estate's 27½ percent block, effectively held the estate's shares as part of a controlling block. The Fifth Circuit reasoned first, that case law did not support any type of "family attribution" in which control of the corporation was attributed among family members, and second, that the valuation concept of a hypothetical willing buyer and a hypothetical willing seller made it improper to view the seller and buyer of a hypothetical sale of the stock as members of the controlling family. 658 F.2d at 1002-1006; accord *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

We endorsed and relied on the reasoning of *Estate of Bright* in *Estate of Andrews v. Commissioner, supra*, where we held that in valuing the decedent's approximately 20-percent interest in the stock of four corporations, discounts for lack of control and marketability were applicable, even though the decedent and his siblings owned all the stock in the corporations. We concluded that "For purposes of valuation, one should construct a hypothetical sale from a hypothetical willing seller to a similarly hypothetical willing buyer," regardless of the fact that "the reality of the situation may be that the stock will most probably be sold to a particular party or type of person." 79 T.C. at 955-956.

Although *Estate of Bright* and *Estate of Andrews* involved the valuation of stock for estate tax purposes, the principles relied on in those cases are equally applicable to the valuation of stock for gift tax purposes. Like the estate tax, the gift tax is imposed upon the act of transfer and is measured by the value of the property *passing* from the donor, and not on the value of the property in the hands of a particular recipient. The gift tax regulations, like the estate tax regulations, rely on the concept of the hypothetical willing seller and willing buyer to determine the value of the property transferred. Sec. 25.2512-1, Gift Tax Regs.

In *Estate of Andrews*, we did remark that "the hypothetical sale should not be construed in a vacuum isolated from the actual facts that affect the value of the stock in the hands of the decedent" (79 T.C. at 956), but as in that case, we do not see any facts here that persuade us to value the J-Seven shares given to the petitioners' sons as anything other than minority interests. The parties' experts agreed that there would be little or no market for a minority interest in J-Seven outside the family; but unlike the case of *Luce v. United States*, 4 Cl. Ct. 212 (1983), relied on by the Commissioner, here there is also no established market for the stock in the existing stockholders or the corporation. In *Luce*, the Claims Court held that no minority discount was warranted in valuing gifted shares in a closely held corporation where there was a well-established market for the shares in its controlling stockholders, its managerial employees, and the corporation itself. The court stated that "the applicable market in which the hypothetical willing buyer may be found need not be one which includes the general public. It is sufficient if there are potential buyers among those closely connected with the corporation." 4 Cl. Ct. at 220-221. Since there was an eager, ready market for the shares in the company or among persons associated with the company, no discount would be needed in order for the hypothetical seller to find a willing buyer. 4 Cl. Ct. at 222. Such is not the case here. The controlling stockholders and J-Seven itself have no history of purchasing the shares of departing stockholders. After making the gifts, the petitioners continued to control the corporation, and it is highly unlikely that either of them would buy back the minority interests that they had given away as part of their estate plan. Likewise, the evidence does not indicate that the sons themselves would be willing or financially able to buy such shares if they were offered at a price even approaching their net asset value. We therefore conclude that discounts for lack of control and marketability are necessary in valuing the shares given by the petitioners in 1979 through 1981.

The petitioners' expert applied a minority discount of 33⅓ percent; he chose 33⅓ percent because that was the average minority discount allowed by various courts in recent years. Taking into account the low earnings power of the corporation, the restrictions imposed by the stock purchase agreement, and the limited marketability of the stock, we are convinced that the expert's discount is altogether justified. Consequently, we find and hold that the fair market value of the stock given by the petitioners to their sons was as follows:

Year of gifts	*Fair market value per share*
1979	$2,207
1980	2,288
1981	2,295

The final issue for decision is whether the gift adjustment agreement executed on December 28, 1979, is effective to avoid the gift taxes otherwise due in 1979, 1980, and 1981.[9] The petitioners contend that the gift adjustment agreement reflects their intent to give each son a certain "value of property" ($50,000), rather than a specific number of shares (25 shares), and that the number of shares reported on their gift tax returns was merely "representative of the value" which they intended to give. They argue that the gift adjustment agreement is similar to the price adjustment agreement upheld in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), in that both were means of overcoming the uncertainty in ascertaining the fair market value of the stock conveyed. The Commissioner, on the other hand, contends that each petitioner made a completed gift of 25 shares, not $50,000, to each son, and relying on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), revg. on other grounds a Memorandum Opinion of this Court, he argues that the gift adjustment is a condition subsequent and void as contrary to public policy.

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[9] Since we have determined that the petitioners undervalued the stock on their 1979 gift tax returns, they underpaid their gift tax in 1979 and, due to the consequent reduction in the available unified credit, in 1980 and 1981, even though they overvalued the stock on their 1980 and 1981 returns. The petitioners and their sons executed a gift adjustment agreement at the time of each gift of stock in 1979, 1980, and 1981. However, we need only decide whether the 1979 agreement is effective because its effectiveness (or lack thereof) determines whether the petitioners underpaid their gift taxes in subsequent years as well.

The gift tax is imposed only when the transfer of property is complete. The regulations provide:

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending on all the facts in the particular case. [Sec. 25.2511-2 (b), Gift Tax Regs.]

See *Smith v. Shaughnessy*, 318 U.S. 176 (1943); *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939); *Burnet v. Guggenheim*, 288 U.S. 280 (1933).

Under the gift adjustment agreement, the petitioners each conveyed 25 shares of J-Seven stock to each son but reserved the power to revoke a part of each gift if it is "finally determined for Federal gift tax purposes" that the fair market value of each share exceeds $2,000.[10] At the time the gifts were made, the petitioners did not possess a presently exercisable right to revoke the gifts in whole or in part. Their power to revoke is contingent upon something over which they have no control. The language of the contingency is ambiguous: it may refer to a determination by the Commissioner, a decision of this Court, a District Court, or the Claims Court, or the outcome on appeal. But, in any event, the power to revest is dependent upon the actions and decisions of third parties. In fact, at the time of the gifts, there was no assurance that the contingency would ever come about because there was no guarantee that the Commissioner would choose to examine the petitioners' gift tax returns.

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[10] The gift adjustment agreement did provide for an upward adjustment in the number of shares gifted if it were finally determined for gift tax purposes that the fair market value of each share was less than $2,000; but we think the donees could not enforce the agreement against the donors because it was unsupported by any consideration flowing from the donees.

Although the rule has been attacked on theoretical grounds,[11] it is settled that if the power retained by the donor is exercisable only upon the occurrence of an event over which he has no control, or only with the concurrence of someone having an interest in the property adverse to his, the reserved power does not amount to dominion and control over the property, and there is a completed gift. *Smith v. Shaughnessy, supra*; *Robinette v. Helvering*, 318 U.S. 184 (1943); *Estate of Goelet v. Commissioner*, 51 T.C. 352, 360 (1968); *Goldstein v. Commissioner*, 37 T.C. 897, 905 (1962); *Estate of Kolb v. Commissioner*, 5 T.C. 588, 593 (1945); *Mack v. Commissioner*, 39 B.T.A. 220, 229 (1939); C. Lowndes, R. Kramer & J. McCord, Federal Estate and Gift Taxes, sec. 28.11 at 719 (3d ed. 1974). The existence of a contingent power to revoke is treated as reducing the value of the gift to the extent of the value of the reserved power (*Smith v. Shaughnessy, supra*); but if the donor retains an interest in the property that "is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift." Sec. 25.2511-1(e), Gift Tax Regs.; see *Robinette v. Helvering, supra*. In the present case, because of the nature of the gift adjustment contingency, the application of these valuation principles creates an apparent paradox: *On the date of the gifts*, the petitioners' retained interests in the stock were not susceptible of valuation because contingent upon the actions of third parties, whose choices and determinations were impossible to predict; however, when this Court determines the value of the stock *as of the date of the gifts*, the values of the petitioners' retained interests are necessarily determined.

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[11] See Macris, "Open Valuation and the Completed Transfer: A Problem Area in Federal Gift Taxation," 34 Tax L. Rev. 273 (1979). Mr. Macris contends that, from a theoretical standpoint, a power to revoke that is subject to a contingency beyond the control of the transferor, and that, consequently, the transfer is incomplete as to the property subject to revocation, "even where the occurrence of the external contingency is virtually impossible." 34 Tax L. Rev. 277. However, Mr. Macris acknowledges that the law currently treats such transfers as complete, and he admits that, at least in cases where the contingency is unlikely to occur, "practically speaking, it may be that substance should prevail over form. The unlikelihood of the occurrence of the contingent event can be seen to eviscerate the donor's power, rendering the transfer complete, thus preventing a deferral of tax on a transfer that is, in substance, irrevocable." 34 Tax L. Rev. 278; fn. refs. omitted.

In *Commissioner v. Procter*, *supra*, the Fourth Circuit found a similar gift adjustment clause to be a condition subsequent and void because contrary to public policy. 142 F.2d at 827. The Commissioner takes the same position (Rev. Rul. 86-41, 1986-12 I.R.B. 9; Rev. Rul. 65-144, 1965-1 C.B. 442). In *Procter*, the taxpayer made a gift in trust. The trust agreement contained the following clause:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created. [142 F.2d at 827.]

The taxpayer contended that, under this clause, the gift did not become effective to the extent it would give rise to a gift tax.

The Fourth Circuit rejected the taxpayer's argument:

> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court. It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained. [142 F.2d at 827.]

The court found the condition contrary to public policy for three reasons: (1) "it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift," (2) "the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case," and (3) the condition is to the effect that the final judgment of a court would be neutralized because of the trust provision necessarily before the court when the judgment is rendered; that is, the condition is not to become operative until there has been a judgment that the donor is liable for the tax, but after the judgment has been rendered, it cannot become operative because the matter involved is concluded and rendered moot by the judgment. 142 F.2d at 827-828.

The third reason is inapplicable here if the term "finally determined" in the gift adjustment agreement is meant to apply before there is a final decision of a court, but in any event, the first two reasons are applicable here and are highly persuasive. If a condition like that involved here is given effect for gift tax purposes, there is no incentive for the Commissioner to challenge the donor's valuation of the property transferred because no gift tax deficiency can result, and the Commissioner has no power to compel the donor to reclaim a portion of the property. It has been suggested that the argument that such "savings clauses" frustrate the enforcement of the gift tax is no longer valid under the unified estate and gift transfer tax system. See C. Strobel & G. Strobel II, "Savings Clauses Can Protect Against Revalued Transfers in Family Transactions," 14 Taxation for Lawyers 22, 24 (1985). When *Procter* was decided, the Federal gift and estate taxes were separate taxes, each with its own rate schedule. If the donor could not recover the excess gift or if his right to revoke lapsed before his death, the excess gift would escape both gift and estate taxation. Now, transfers during life and at death are subject to a single unified rate schedule, and the rates are progressive on the basis of cumulative lifetime and deathtime transfers. It appears that in calculating the estate tax, incorrectly valued gifts may be revalued in determining "adjusted taxable gifts" for purposes of section

2001(b),[12] and when such gifts are cumulated with the taxable estate, any upward adjustment in the value of the gifts would result in an increase in estate tax liability. However, we are not persuaded that the mere possibility of estate taxation is sufficient. If, at death, the Commissioner fails to challenge the gift's valuation, the excess value of the gift will pass from the donor's estate without ever being subject to the transfer tax, and in every case, the payment of the tax due on the excess gift is deferred.

Furthermore, a condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of "trifling with the judicial process" condemned in *Procter*. If valid, such condition would compel us to issue, in effect, a declaratory judgment as to the stock's value, while rendering the case moot as a consequence. Yet, there is no assurance that the petitioners will actually reclaim a portion of the stock previously conveyed to their sons, and our decision on the question of valuation in a gift tax suit is not binding upon the sons, who are not parties to this action. The sons may yet enforce the gifts.

King v. United States, *supra*, relied on by the petitioners, is clearly distinguishable. In that case, the taxpayer created trusts for the benefit of his four children and appointed his lawyer trustee. The taxpayer then sold stock in his closely held corporation to the trusts in an arm's-length transaction, free from any donative intent. The trusts executed notes for $2 million based on a price of $1.25 per share, and the taxpayer retained legal title to the stock as security for payment of the purchase price. In addition, letter agreements were drawn up that provided that if the IRS ever determined that the fair market value of the stock as of the time of transfer was greater or less than the purchase price, the price would be adjusted to the fair market value determined by the Service. The IRS subsequently determined that the stock was worth $16 per share and that there was due a gift tax on the value in excess of the face amount of the notes. It appears that the taxpayer and the trusts made no attempt to make a price adjustment, but the adjustment would have been an empty formality, since the trust corpus—shares in the corporation, which was bankrupt by the time of trial—was worthless.

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[12] The estate tax imposed by sec. 2001(a) is equal to the excess (if any) of the tentative tax (computed in accordance with the rate schedule set forth in sec. 2001(c)) on the sum of the taxable estate and adjusted taxable gifts, over the aggregate amount of gift tax payable with respect to gifts made by the decedent after Dec. 31, 1976. Sec. 2001(b) (as in effect during the years in issue). For purposes of sec. 2001(b), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of sec. 2503) made by the decedent after Dec. 31, 1976, other than gifts which are includable in the gross estate of the decedent. The term "taxable gifts" means the sum of the values of the gifts made during the taxable period, less annual exclusions and less certain deductions. Sec. 2503. Sec. 2504(c) provides that, for gift tax purposes, if the valuation of a gift made in a preceding calendar year or quarter is at issue, and if the statutory period within which an assessment may be made with respect to the gift has expired and a tax has been assessed or paid for such preceding calendar year or quarter, then the value of such prior gift shall be the value that was used in computing the tax for the last preceding calendar year or quarter for which a gift tax was assessed or paid. However, there is no similar time limit on the correction of erroneously valued prior taxable gifts (adjusted taxable gifts) for estate tax purposes.

The Tenth Circuit in *King* held that the transfers were not subject to the gift tax because there was no donative intent and because the sales were made in the ordinary course of business at arm's length. Generally, if property is transferred for less than an adequate and full consideration in money or money's worth, the excess of the value of the property transferred over the value of the consideration received "shall be deemed a gift." Sec. 2512(b). However, section 25.2512-8 of the Gift Tax Regulations provides that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." Relying on the regulation, the court held that the price adjustment clause eliminated the possibility of donative intent because, when the IRS determined that the stock was worth $16 per share, the trusts became obligated to pay the higher price. The court upheld the District Court's finding that the parties inserted the price adjustment clause only because it was difficult, if not impossible, to accurately value the stock at the time of its transfer. The court also stated that the gift tax is intended to prevent taxpayers from using gifts to reduce their taxable estates and, consequently, found it significant that the taxpayer's estate was in no way diminished by the transfer of stock to the trusts (apparently, because the stock had since become worthless).

The factual findings supporting the holding in *King* a open to question (*Harwood v. Commissioner*, 82 T.C. at 27 n. 23),[13] but, in any event, the case is distinguishab because no arm's-length sale was involved here. We disagr with the petitioners' contention that because it attempts t overcome the difficulties associated with the valuation o closely held stock, the gift adjustment agreement is lik that in *King*; the adjustment clause in *King* operated t insure that no unintended gift was made, but the agreeme here purports to retroactively alter the amount of a otherwise completed gift. Furthermore, since there is n assurance that the petitioners will either recover the exces shares or, at the time of their deaths, possess the power t recover such shares, and since the shares are not worthles the petitioners' estates may be reduced by the transfer o the shares. See *Harwood v. Commissioner*, 82 T.C. at 275 n 28.

Accordingly, we conclude that the gift adjustment claus involved here is void as contrary to public policy and has n effect on the gift taxes otherwise due on the gifts of stoc to the petitioners' sons.

Decision will be entered under Rule 15

FISCHER INDUSTRIES, INC. AND SUBSIDIARIES, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 40305-84. Filed July 17, 1986.

Prior to 1975, Mayfran, a member of P's consolidated group, calculated the value of its closing inventory under the first-in, first-out (FIFO) method of inventory accounting. For its taxable year 1975 and each subsequent taxable year, Mayfran correctly calculated the value of its closing inven-

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[13] In *Harwood v. Commissioner*, 82 T.C. 239, 271 n. 23 (1984), affd. in an unpublish opinion 786 F.2d 1174 (9th Cir. 1986), we made the following observation:

"We question whether the buyer's willingness to pay whatever amount the IRS determin the stock to be worth evidences an arm's-length transaction. If anything, it tends to show th the trustee did not bargain at arm's length with the trust grantor, since the trustee evidentl did not care what price it paid for the stock, but cared only that no gift tax be incurred by th grantor-seller."

tory under the last-in, first-out (LIFO) method. P failed to file a Form 970, Application to Use LIFO Inventory Method, or the information requested by Form 970, on or with its original, consolidated Federal income tax return for the taxable year 1975. The information requested by Form 970 was, however, fully set forth in the work papers of P's accountants that were provided to R during the course of its audit of P. P's 1975 financial statements noted Mayfran's change to the LIFO method. On April 16, 1986, shortly after trial, P filed an amended return for the taxable year 1975, attaching a properly completed Form 970. *Held*, with the change in regulations P's failure to file Form 970 does not of itself prevent a valid LIFO election; the stricter rule of *Textile Apron Co. v. Commissioner*, 21 T.C. 147 (1953), is no longer followed. *Held, further*, providing P's financial statements and its accountants' work papers for its taxable year 1975 to R during R's audit of P in 1979 does not constitute substantial compliance with R's regulations to elect LIFO for the taxable year 1975. *Held, further*, on its return, P did not give R notice of Mayfran's intent to elect LIFO, and therefore, Mayfran failed to comply substantially with the requirements of R's regulations; P's filing of a completed Form 970 subsequent to trial did not constitute substantial compliance as soon as practicable with R's regulations. *Held, further*, P did not elect the LIFO method for the taxable year 1975.

Harlan Pomeroy, for the petitioners.
Richard S. Bloom, for the respondent.

WILLIAMS, *Judge*: The Commissioner determined deficiencies in petitioners' Federal income tax for each of the taxable years 1975 through 1978 and for 1980 and additions to tax for fraud pursuant to section 6653(b)[1] in the following amounts:

		Sec. 6653(b)
TYE Apr. 30—	*Deficiency*	*additions to tax*[1]
1975	$349,436	$174,718
1976	174,699	87,335
1977	246,311	123,156
1978	22,698	(not applicable)
1980[2]	177,311	(not applicable)

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years at issue in this case, unless otherwise indicated.

[1] Respondent, by amendment to answer, proposed increases in the additions to tax pursuant to sec. 6653(b); the proposed revised additions are as follows: for the taxable year 1975—$442,357; for the taxable year 1976—$385,687; and, for the taxable year 1977—$334,355. Petitioners concede the correctness of the revised additions to tax.

[2] Adjustments were made but no deficiency was determined for the taxable year 1979 as petitioners incurred a consolidated net operating loss for that year; therefore petitioners' taxable year 1979 is not before us. Although we do not have jurisdiction over taxable year 1979, we may consider facts relating to any taxable year that are relevant to the issues to be decided in those taxable years before this Court. *Martz v. Commissioner*, 77 T.C. 749 (1981).

Following concessions by the parties, the sole issue that the Court must decide now is whether Mayfran, Inc., a member of petitioners' consolidated group, elected for 1975 to value its inventory under the last-in, first-out (LIFO) method of inventory accounting.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioners' principal place of business at the time the petition was filed was Mayfield Heights, Ohio.

Petitioners are corporations organized under the laws of the State of Ohio. Petitioner Fischer Industries, Inc. (Fischer), owned four subsidiaries during the period 1975 through 1980—petitioners American Monorail, Inc., American Tool, Inc., M.G. Building Co., and Mayfran, Inc. (Mayfran). Mayfran, a manufacturer during the years at issue in this case, owned a foreign subsidiary, Mayfran GmbH. Mayfran was merged with Fischer, the surviving corporation, on January 3, 1979. Fischer filed consolidated Federal income tax returns (Forms 1120) for each of the taxable years ended April 30, 1975 through 1980, on which the income of each of its domestic subsidiaries was included. As a foreign corporation, Mayfran GmbH could not be included in petitioners' consolidated returns. An information return for Mayfran GmbH was filed with petitioners' consolidated returns, however, for each of the years at issue in this case.

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[2] Because of our holding, we will reach a second issue involving the effect of a merger of Mayfran, Inc., into its parent on use of the LIFO method for 1979 and later years. A special trial session is scheduled for trial of this issue.

Prior to the taxable year 1975, the value of Mayfran's inventory was calculated on the first-in, first-out (FIFO) method of inventory accounting while Fischer and its other domestic subsidiaries calculated the value of their inventories under the LIFO method. For the taxable year 1975, however, the value of Mayfran's closing inventory was calculated on the LIFO method. Thereafter, Mayfran calculated the value of its inventories under the LIFO method. Mayfran GmbH continued to calculate the value of its inventory on the FIFO method during the years before this Court.

On their consolidated Federal income tax return for the taxable year 1975 (the 1975 return), petitioners reported that both the LIFO and the FIFO methods were used in their inventory accounting. Petitioners did not answer a question on the 1975 return which asked whether there was any substantial change in determining quantities, costs, or valuations of inventories. No Form 970, Application to Use LIFO Inventory Method, was filed with the 1975 return or with the returns filed by petitioners for any of the remaining taxable years at issue in this case until April 16, 1986, shortly after trial, when petitioners filed an amended return for 1975 attaching a properly completed Form 970. Prior to April 16, 1986, the information requested by Form 970 was not provided on or with petitioners' income tax returns for any of the taxable years 1975 through 1980. Petitioners filed returns for each of the taxable years 1976 through 1980 on the indicated dates: 1976—on January 28, 1977; 1977—on January 18, 1978; 1978—on October 16, 1978; 1979—on October 18, 1979; and 1980—on January 19, 1981. On each of these returns, petitioners reported that LIFO was the method of inventory valuation used and that there was no substantial change in determining the quantities, costs, or valuations of inventories from the prior year.

Petitioners' accounting firm conducted an audit of petitioners' records for the taxable year 1975, and pursuant to its normal audit procedures prepared a certified financial statement for that year. The 1975 financial statement noted that Mayfran had changed from the FIFO to the LIFO method of inventory accounting that year. Petitioner provided a copy of the 1975 financial statement to respondent in 1979, in response to respondent's request during its own audit of petitioners for documentation to support an election by Mayfran to use the LIFO method for the taxable year 1975.[3] The information requested by Form 970 and respondent's regulations was fully set forth in the work papers of petitioners' accountants that were provided to respondent during the course of its audit of Fischer.

OPINION

Section 472 permits a taxpayer to elect, in accordance with applicable regulations, the LIFO method of inventory accounting. The regulations provide in part that:

> (a) The LIFO inventory method may be adopted and used only if the taxpayer files with his income tax return for the taxable year as of the close of which the method is first to be used a statement of his election to use such inventory method. The statement shall be made on Form 970 pursuant to the instructions printed with respect thereto and to the requirements of this section, or in such other manner as may be acceptable to the Commissioner. * * * [Sec. 1.472-3(a), Income Tax Regs.]

The regulation has been changed significantly since we decided *Textile Apron Co. v. Commissioner*, 21 T.C. 147 (1953), when we last considered the effect of a failure to file a Form 970 on making the LIFO election.[4] In *Textile Apron* we held, based on respondent's regulations that, despite the taxpayer's statement on the original return for its first taxable year that it had calculated its inventory by using LIFO valuation, failure to file a Form 970 was fatal to the LIFO election. After *Textile Apron* was decided, the regulation was amended to permit a taxpayer to elect the LIFO method (1) by filing a Form 970 or (2) in such other manner as may be acceptable to the Commissioner. Filing with the return the information that is required to be reported on Form 970 satisfies these regulations.[5] We believe that this change in the regulations reflects, in part, the opinions of this Court and others decided since *Textile Apron* that if a taxpayer substantially complies with the procedures for making an election, the election will be effective. See, e.g., *Columbia Iron & Metal Co. v. Commissioner*, 61 T.C. 5 (1973). Consequently, a mere failure to file a Form 970 is not fatal to Mayfran's electing LIFO. We will no longer follow the stricter rule of *Textile Apron Co. v. Commissioner*.

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[3] Respondent conducted an audit of petitioners for certain taxable years prior to 1975, and in 1979, expanded the audit to include petitioners' taxable year 1975.

[4] Prior to its amendment sec. 1.472-3(a), Income Tax Regs., provided that the LIFO method could be elected by filing a statement of election "in triplicate on Form 970, and pursuant to the instructions printed thereon and to the requirements of this section." The quoted language was deleted from the amended regulation. It was replaced by the last sentence in the paragraph quoted above. All other language in the regulation remained unchanged.

[5] Respondent has adopted the position that a taxpayer's election to use LIFO is acceptable if all of the information required on, or to be filed with, the Form 970 is included with the

Petitioners failed not only to file a Form 970, but also to provide the information required by Form 970 with their original 1975 return—the year for which Mayfran first used the LIFO method. Petitioners did, however, correctly employ the LIFO method of accounting on their 1975 return. Respondent does not dispute the correctness of petitioners' methodology or the accuracy of the values employed in so accounting for Mayfran's inventory.

Despite their failure to provide the required information, petitioners contend that Mayfran substantially complied with the required procedure (1) by using the LIFO method correctly on the 1975 return and on returns for each subsequent year, (2) by furnishing to respondent all information, records, and calculations pertaining to Mayfran's change in inventory accounting when requested to do so during respondent's audit of the 1975 return, and (3) by "perfecting" the election by filing on April 16, 1986, Form 970 with an amended return for 1975.[6] Further, petitioners

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taxpayer's timely filed Federal income tax return for the taxable year as of the close of which LIFO is first to be used. Rev. Proc. 74-2, 1974-1 C.B. 412, 413.

[6] Petitioners allude on brief to having filed the Form 970 at trial. As the transcript plainly shows, the form offered and received into evidence was not for the purpose of petitioners' making their election but for the purpose of petitioners' proof that the information required by the form was easily prepared by petitioners' accountants from the information made available to respondent during the audit of the 1975 return. The Court understood petitioners' position to be that because all necessary information was readily available to respondent and because preparation of the form was so easy, the failure to file it should be viewed as immaterial. Further, the Court thought that petitioners were trying to show that the election had been made not later than when such information was furnished to respondent during the audit. The Court in no way intimated that we were the proper place for petitioners to file their election form or that we could receive the Form 970 in lieu of petitioners' filing the form with the respondent. In any event, as petitioners' sophisticated counsel should be aware, this Court is not an administrative tribunal and cannot receive, on behalf of the United States, a form that should be filed with respondent. *Hosking v. Commissioner*, 62 T.C. 635 (1974), is not to the contrary. An election to use income averaging at trial is appropriate because income averaging determines the proper rate of tax, not the taxpayer's income, is computational only, and for any eligible taxpayer, is a choice that requires ministerial review by respondent. Compare sec. 1.472-3(b), Income Tax Regs.

contend that to "disturb" Mayfran's LIFO inventory accounting employed consistently and correctly for each of the years before the Court would be an "extreme and unwarranted" sanction.

In support of their position that they have substantially complied with the procedures for electing LIFO, petitioners rely heavily on the absence of any time specified by the regulations for making the election. Relying on *Roy H. Park Broadcasting, Inc. v. Commissioner*, 78 T.C. 1093 (1982), petitioners contend that in the absence of a requirement that the election be filed with an *original return*, filing the Form 970 with an amended return fully satisfies the timeliness requirement of section 472. Although petitioners' arguments are well crafted, we are unpersuaded that Mayfran made a timely election for 1975.

In general, substantial compliance with election requirements entails, at a minimum, a clear expression of the taxpayer's intention to elect appearing either on the original return or, if the circumstances necessitating an election arise after the filing of an original return, as soon as practicable on an amended return. *Knight-Ridder Newspapers v. United States*, 743 F.2d 781 (11th Cir. 1984); *Atlantic Veneer Corp. v. Commissioner*, 85 T.C. 1075 (1985). As we said in *Atlantic Veneer Corp. v. Commissioner*, *supra* at 1082-1083:

> We have examined the cases as to what constitutes a statement of election under various provisions of the Internal Revenue Code and have found that, absent a formal election, a submitted return and its attached schedules must evidence an affirmative intent on taxpayer's part to make the required election and be bound thereby. E.g., *American Air Filter Co. v. Commissioner*, 81 T.C. 709, 720-723 (1983); *Tipps v. Commissioner*, [74 T.C. 458,] 468-471 [(1980)]; *Hewlett-Packard Co. v. Commissioner*, 67 T.C. 736, 747-750 (1977). Failure to manifest such intent has repeatedly resulted in taxpayer's alleged election being rejected. E.g., *Knight-Ridder Newspapers v. United States*, 743 F.2d 781, 793-797 (11th Cir. 1984); *Young v. Commissioner*, 83 T.C. 831, 839-840 (1984); *Estate of Shaggs v. Commissioner*, [75 T.C. 191,] 205-208 [(1980), affd. per curiam 672 F.2d 756 (9th Cir. 1982)]; *Valdes v. Commissioner*, 60 T.C. 910, 913-915 (1973).

Park Broadcasting is not to the contrary. The taxpayer in *Park Broadcasting* affirmatively stated its election on an amended return filed as soon as practicable after the election was permitted by a key change in Federal regulations that occurred *after* the taxpayer had filed its original return. Petitioners also rely on *Dougherty v. Commissioner*, 60 T.C. 917 (1973), but *Dougherty* also involved a change in circumstances occurring after the original return had been filed. In this case, no impediment existed to Mayfran's election on petitioners' 1975 return. Indisputably Mayfran intended to use the LIFO method for taxable year 1975, and the record is clear that petitioners could have taken all steps on the 1975 return that were necessary to perfect the election. We look in vain, however, for any clear expression of that intent on the 1975 return.

Petitioners' original 1975 return gave no indication that the value of Mayfran's closing inventory was being computed under the LIFO method. From petitioners' returns filed prior to audit, respondent could not determine (1) that Mayfran used the LIFO method, (2) which LIFO methodology was used, or (3) whether petitioners' calculations correctly employed the LIFO method. Moreover, the face of every indication on the original return was that Mayfran had chosen to retain the FIFO method. Petitioners failed to answer the question asking whether any change in inventory accounting had occurred, and furthermore, stated explicitly that the FIFO method was used to calculate inventory.[7] No change in method can be discerned from petitioners' use of the correct LIFO figures on the 1975 return.

Petitioners rely on *Grynberg v. Commissioner*, 83 T.C. 255 (1984), to support their contention that use of the LIFO figures without more expresses their intent to elect LIFO. The elective choice in *Grynberg*, however, involved applying a limit of either 30 percent or 50 percent of adjusted gross income, and it was, therefore, clear from the face of the original return which limit the taxpayer had chosen and which elective choice the taxpayer had made. Moreover, unlike the election at issue in *Grynberg*, the LIFO election involves far more than a simple computation.[8] As petitioners' accountant testified, the transition from FIFO to LIFO is complex and requires much work and attention to detail. The LIFO regulations recognize both this complexity and the care with which respondent seeks to review a LIFO election. Further, there is more than one LIFO methodology, and respondent is entitled to know which one the taxpayer is using at the time the inventory figures are reported. See sec. 1.472-8, Income Tax Regs.

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[7] Petitioners attempt to explain the reference in the return to the use of FIFO as an allusion to the inventory accounting of Mayfran GmbH. We think that explanation is creative but not persuasive. As petitioners' accountant testified, the failure to answer the question on the return pertaining to any change in inventory accounting was "a goof," and we think the reference to FIFO is better described the same way.

The statute itself mandates that respondent have an opportunity for a complete review of petitioners' use of LIFO. Sec. 472(c). Implementing this mandate, the regulations seek to ensure that respondent has notice of the change in inventory methods. Such notice is essential to any decision to audit the change. The notice to respondent contemplated by section 472(c) is not given without having a clear expression of intent to elect LIFO appear on the first return employing the LIFO method.

The correct use of the LIFO method on the return, together with making the financial statements and workpapers available for inspection, without more, does not serve to give respondent notice of the change to LIFO. Furnishing the required information to respondent on audit, as petitioners did, also does not constitute the necessary *clear expression* of intent on the return to use the LIFO method. It does not give respondent a timely opportunity to know of the highly significant change in inventory accounting, which section 472(c) states deserves his attention. Further, the taxpayer, with hindsight and prior to audit, would not be precluded from amending the figures on the original return to reflect Mayfran's FIFO inventory method.

As in *Knight-Ridder Newspapers v. United States*, *supra*, the significance of the election at issue here reaches far beyond the year in which the election was purportedly made. A LIFO election is "irrevocable" (sec. 1.472-5, Income Tax Regs.), and, at least with respect to the LIFO election, there should be a strong judicial policy favoring a clear expression on the original return of the intent to make the election. What the Eleventh Circuit had to say about electing the class-life system of depreciation in *Knight-Ridder Newspapers* is equally applicable here:

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[8] The line of cases involving an election to use the installment method of accounting for gain on certain sales also involves a comparatively simple computational election. E.g., *Reaver v. Commissioner*, 42 T.C. 72 (1964).

> A related regulatory goal is that the Commissioner actually know an election has been made. This ultimately serves the policy of minimizing disputes between taxpayers and the Internal Revenue Service. *See* Treas. Reg. § 1.167(a)-12(a)(1). A clear indication of the taxpayer's election to employ the class life system removes any ground for dispute over whether the system applies and what the appropriate useful life should be. * * * [743 F.2d at 795.]

Petitioners correctly point out that to elect LIFO for Federal income tax purposes, their financial statements must employ the LIFO inventory accounting method. Sec. 1.472-2(e), Income Tax Regs. Petitioners did in fact change Mayfran's inventory accounting method for financial statement purposes for their fiscal year ended April 30, 1975, but we cannot view petitioners' financial statements as the clear expression of Mayfran's intent to elect the LIFO method for Federal income tax purposes. There is no reverse conformity rule—a taxpayer's use of LIFO for financial reporting purposes does not mandate the use of LIFO for Federal income tax purposes—petitioners were not bound to use the LIFO method on their tax return because they had employed it in their financial statements.[9]

Petitioners also argue that, by filing their Form 970 with an amended return while the statute of limitations for taxable year 1975 was open, they perfected Mayfran's LIFO election. On brief petitioners describe this filing, made within weeks after trial, as an afterthought. We also believe that such filing was an empty formality and that the filing satisfies none of the reasons for the clear expression standard which we believe applicable to determining whether a LIFO election has been made. Further the filing does not constitute substantial compliance as soon as practicable with the regulations. Compare *Roy H. Park Broadcasting, Inc. v. Commissioner*, 78 T.C. 1093 (1982).

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[9] Of course, the years before the Court were a period of intense inflation. It was not a sensible business practice to use LIFO for financial reporting purposes—thus reducing reported gross income by current (and inflating) costs—while using FIFO for tax purposes—thus reducing income by comparatively smaller historic costs. In other words, in an inflationary economy, using the LIFO method will result in lesser income than using the FIFO method. Thus, by using FIFO for Federal income tax purposes and LIFO for financial reporting purposes, petitioners would be, in effect, reporting higher income to the Internal Revenue Service than to their shareholders. In a deflationary economy, the converse would be true; petitioners would be reporting lesser income to the Internal Revenue Service than to their shareholders.

We, therefore, hold that petitioners did not satisfy the requirements of section 472 and the regulations for taxable year 1975 and, consequently, did not elect the LIFO method of inventory accounting for that year.

Petitioners contend in the alternative that they perfected the LIFO election for the taxable year 1979 when they provided respondent with their accountants' work papers during respondent's audit of the taxable year 1975.[10] Since the work papers contained the information required by Form 970, it is argued, a valid election was made at the time such information was provided to respondent. We are unable to agree. First, the information contained in the work papers pertained only to petitioners' taxable year 1975. Second, the 1979 return has no clear expression of intent to elect LIFO commencing with that year. Third, there is no evidence in the record that would support our finding that had petitioners' inventory for the taxable years 1975 through 1978 been calculated under the FIFO method, petitioners would have first elected LIFO for the taxable year 1979. We conclude that no valid LIFO election was made in the years before us.

Decision will be entered after the special trial session.

HARRY H. AND GLORIA J. TAKAHASHI, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10640-83. Filed July 21, 1986.

On their 1981 Federal income tax return Ps, high school science teachers, claimed, as education expenses under sec. 162(a), I.R.C. 1954, certain expenses which they incurred to attend a cultural seminar in Hawaii. Also, on their 1979, 1980, and 1981 returns, Ps claimed losses in connection with

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[10] A hearing was held on June 6, 1986, at which the parties presented oral arguments on the issue of petitioners' expression of intent to make an election on their 1975 return, and on the issue of whether a valid election was made for the taxable year 1979.

the operation of a farm. *Held,* a course providing general cultural enrichment is not sufficiently germane to the teaching of science to bring the course within the category of a "refresher," "current developments," or "academic or vocational" course as required by regulations to qualify the course for deductible education expenses. Sec. 1.162-5(c)(1), Income Tax Regs. *Held, further,* because Ps did not engage in the operation of the farm for profit within the meaning of sec. 183, I.R.C. 1954, they may not claim farm expenses in excess of farm income.

Terence Nunan and *Jeffrey K. Riffer,* for the petitioners.
Marilyn Devin and *J. Robert Cuatto,* for the respondent.

NIMS, *Judge*: Respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Year	*Deficiency*	*Additions to tax sec. 6653(a)* [1]
1979	$1,536	. . .
1980	1,389	$69.45
1981	2,686	134.30

After concessions, the issues for decision are: (1) Whether petitioners are entitled to deduct certain expenses which they incurred to attend a seminar in Hawaii as education expenses under section 162(a); (2) whether the operation of petitioner's farm was an activity "not engaged in for profit" within the meaning of section 183; and (3) whether petitioners are liable for additions to tax for negligence or intentional disregard of rules and regulations under section 6653(a). For reasons of convenience, we have combined our findings of fact and opinion with respect to each issue.

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Harry H. Takahashi and Gloria J. Takahashi husband and wife, resided in Hacienda Heights, California, at the time they filed the petition herein.

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[1] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 in effect for the years in question. All Rule references are to the Tax Court Rules of Practice and Procedure.

Issue 1. Education Expenses

During the years in issue, petitioners were employed as science teachers by the Los Angeles Unified School District. Approximately 25 percent of Mrs. Takahashi's students were minorities while almost all of Mr. Takahashi's students were minorities. Most of the minority students taught by petitioners were Hispanic.

Pursuant to article 3.3 of the California State Education Code, a teacher employed by the Los Angeles Unified School District must complete a minimum of two semester units in a course of study dealing with multicultural societies to receive promotions and salary increases. During 1981, petitioners attended a seminar held in Hawaii entitled "The Hawaiian Cultural Transition in a Diverse Society" which satisfied the requirements of article 3.3.

Petitioners, together with their 2 1/2-year-old son, spent 10 days in Hawaii. Petitioners attended the seminar on 9 out of the 10 days during which they were in Hawaii. The seminar program lasted from 1 to 6 hours each day and consisted of classroom instruction as well as tours of Polynesian cultural attractions and visits to the homes of local natives. When petitioners were not participating in the seminar they would take their son sightseeing or spend time relaxing at the beach.

Petitioners incurred expenses totaling $2,373 in connection with their trip to Hawaii. A portion of these expenses were incurred for their son's travel and meals as well as for personal activities engaged in by petitioners which were unrelated to the seminar.

On Form 2106 (Employee Business Expenses) attached to their 1981 Form 1040, petitioners claimed the expenses they incurred in connection with their Hawaiian trip as an education expense under section 162(a). In the notice of deficiency, respondent disallowed this deduction in full with the explanation that petitioners had not established that the expenses were paid or incurred during the taxable year or that the expenses were ordinary and necessary to their business.

Under section 1.162-5(a), Income Tax Regs., education expenses are deductible as ordinary and necessary business expenses if the education (1) maintains or improves skills required by the individual in his employment or other trade or business, or (2) meets the express requirements of the individual's employer. If a taxpayer incurs education expenses while traveling away from home which satisfy one or both of these tests, his expenditures for travel, meals, and lodging incurred while away from home are deductible only if the individual travels away from home primarily to obtain education. Sec. 1.162-5(e)(1), Income Tax Regs. If the taxpayer travels away from home primarily for personal reasons, only expenditures incurred for meals and lodging during the time actually spent participating in deductible education pursuits are allowable. Sec. 1.162-5(e)(1), Income Tax Regs.

Petitioners do not contend nor does the record contain any evidence that petitioners' attendance at the seminar was required by their employer.[2] Rather, petitioners contend that because the seminar on "Hawaiian Cultural Transition in a Diverse Society" enabled them to better understand their minority students, the seminar maintained or improved skills required by them to teach science to minority students. Petitioners further contend that they traveled to Hawaii primarily to attend the seminar. Petitioners therefore conclude that the expenses they incurred in connection with the seminar, including travel, meals, and lodging, are fully deductible as education expenses under section 162(a).

Respondent contends that petitioners have not established that the seminar maintained or improved skills required by them to perform their jobs as science teachers, and, therefore, that none of the expenses petitioners incurred in connection with their trip to Hawaii are deductible. Respondent further contends that even if the seminar maintained or improved petitioners' teaching skills, petitioners' education expense deduction should not be allowed because petitioners traveled to Hawaii primarily for a vacation rather than to obtain education. Finally, respondent contends that even if petitioners traveled to Hawaii primarily to obtain education, they have provided no records or credible testimony upon which to allocate the cost of their Hawaiian trip between deductible business expenses and nondeductible personal expenses.

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[2] Sec. 1.162-5(c)(2), Income Tax Regs., provides in pertinent part that "Only the minimum education necessary to the retention by the individual of his established employment relationship, status, or rate of compensation may be considered as undertaken to meet the express requirements of the taxpayer's employer." The seminar attended by petitioners satisfied the requirements of art. 3.3 of the California State Education Code and therefore made petitioners eligible for promotions and salary increases. Petitioners' participation in this seminar in no way affected the retention of their current employment relationship, status, or rate of compensation.

On the record before us, we do not think that petitioners' participation in the seminar maintained or improved skills required by them to perform their jobs as science teachers, and petitioners have conceded that their attendance was not required by their employer. Consequently, since petitioners fail to satisfy the threshold tests of section 1.162-5(a) of the regulations, we need not consider whether petitioners have satisfied the travel provisions of section 1.162-5(e) of the regulations.

When a taxpayer claims, pursuant to the first of the tests contained in section 1.162-5(a) of the regulations, that an education expense was incurred in order to maintain or improve his existing skills, he must demonstrate a connection between the course of the study and his particular job skills. *Schwartz v. Commissioner*, 69 T.C. 877, 889 (1978), citing *Baker v. Commissioner*, 51 T.C. 243 (1968). We do not think petitioners have demonstrated this connection Although Mrs. Takahashi cited "greater rapport" and "better understanding of people," she could point to "no real tangible thing" to connect the Hawaiian multicultural course which she took with the skills required of a science teacher. Similarly, with respect to Mr. Takahashi, the record shows no evidence that the course which he attended in Hawaii had any nexus with his teaching of science. Mr Takahashi did not testify at the trial.

Petitioners cite *Hilt v. Commissioner*, T.C. Memo 1981-672, as illustrating a situation where the education travel deduction was disallowed only because the taxpayers "did not engage in any specific course of study or spend any time acquiring information from individuals specifically knowledgeable in the areas of Hawaiian culture or history." 42 T.C.M. 1718, at 1721-1722, 50 P-H Memo T.C. par 81,672, at 81-2613. As in the case before us, *Hilt* involved California teachers who traveled to Hawaii with a child and claimed section 162(a) education expense deductions. Th deductions claimed in *Hilt* were based in some part at least upon taxpayers' obtaining "professional growth units" under California law which, when obtained, would have increased taxpayers' salary levels.[3]

Petitioners apparently wish us to infer from the above-quoted language in *Hilt* that any expenditures incurred for general cultural enrichment, if duly substantiated, will be allowable as education expense deductions. However, in the context of petitioners' professional duties as science teachers, the Hawaiian Cultural Transition course does not in our judgment fall within the category of a "refresher," "current developments," or "academic or vocational" course required by the regulations. Sec. 1.162-5(c)(1), Income Tax Regs. The Hawaiian Cultural Transition course is simply not sufficiently germane to the teaching of science to bring the course within the category of expenditures for education which maintains or improves skills required by the individual in his employment. Sec. 1.162-5(a)(1), Income Tax Regs. We accordingly hold for respondent on this issue.

Issue 2. Farm Losses

On their Federal income tax returns for the years in issue, petitioners claimed losses from the operation of a 40-acre grape farm (the farm) which Mrs. Takahashi (petitioner) owned in Fresno County, California. The farm had originally been owned by petitioner's grandfather and had been petitioner's family home during her childhood. Petitioner had purchased the farm in January 1972, from her uncle for approximately $120,000, the consideration consisting of a cash downpayment and an interest-bearing note.

At the time petitioner purchased the farm, her father was farming the property. In order to provide her father with steady employment and old-age security, petitioner and her father entered into an oral agreement whereby her father would operate, manage, and work the farm in exchange for net profits, if any. Petitioner's father agreed to pay all expenses which were incurred for labor, transportation, and equipment while petitioner agreed to pay all other expenses which were incurred in connection with the operation of the farm. Pursuant to this agreement, petitioner would receive farm income to the extent of the farm expenses which she incurred during the year, while her father would receive any remaining income. They further agreed, however, that regardless of the profitability of the farm, petitioner's father would receive income sufficient to support himself and his wife. In the event the farm operations resulted in a net loss, all losses would be allocated to petitioner.

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[3] Mrs. Takahashi testified as to her belief that her husband did, in fact, receive a raise as a result of his art. 3.3 credits. As for herself, there was no advancement possible since she was already "at the end of the salary scale."

On Schedule F (Farm Income and Expenses) attached to their Forms 1040 for 1979, 1980, and 1981, petitioners reported the following income, expenses, and losses with respect to the operation of the farm:

	1979	*1980*	*1981*
Income	$10,000	$10,000	$10,000
Expenses	14,494	14,281	12,048
Profit (loss)	(4,494)	(4,281)	(2,048)

In the notice of deficiency, respondent determined that petitioner's farming activities were "not engaged in for profit" within the meaning of section 183 and, therefore, he disallowed all farm expenses in excess of farm income. The issue we must decide is whether petitioner engaged in the operation of the farm for profit.[4] It seems self-evident that she did not, since under the agreement with her father, any net profit would have inured to him.

A taxpayer must engage in an activity with the primary purpose and objective of making a profit in order to fully deduct expenses under either section 162 or section 212. *Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981). "While a reasonable expectation of profit is not required, the taxpayer's profit objective must be bona fide." *Fox v. Commissioner*, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner*,

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[4] In an amended answer filed on Aug. 27, 1985, respondent alternatively alleged that: (1) Gloria and her father operated the farm as a partnership; (2) during the years in issue, Gloria reported a loss in connection with the partnership's farming activities while her father reported income from the partnership's farming activities; (3) the allocation of farm losses to Gloria and farm income to her father constitutes an improper special allocation under sec. 704(b); and (4) therefore, Gloria is not entitled to claim the partnership losses during the years in issue. On brief, respondent informed the Court that he had decided to abandon this argument.

Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984); *Dreicer v. Commissioner*, 78 T.C. 642, 644-645 (1982), affd. without opinion (D.C. Cir. 1983).

The issue of whether a taxpayer engaged in an activity with the requisite objective of making a profit is one of fact to be resolved on the basis of all the facts and circumstances. *Lemmen v. Commissioner*, 77 T.C. 1326, 1340 (1981). The burden of proving the requisite intention is on petitioners. *Sabelis v. Commissioner*, 37 T.C. 1058, 1062 (1962); Rule 142(a).

Section 183 allows deductions for ordinary and necessary expenses arising from an activity not engaged in for profit only to the extent of gross income derived from such activity, less the amount of those deductions which are allowable regardless of whether or not the activity is engaged in for profit.[5]

By letter dated June 24, 1982, petitioner informed an agent for the Internal Revenue Service that her objective with respect to the operation of the farm was as follows:

> My share of the income? I receive only what is needed to meet my financial obligations. My intent is not to make money but to have a tax

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[5] Sec. 183 reads, in relevant part, as follows:

SEC. 183(a). GENERAL RULE.—In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) DEDUCTIONS ALLOWABLE.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) PRESUMPTION.—If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.

> shelter and mostly to help my folks, whose income is solely from this small farm. The costs of operating a raisin farm ha[ve] increased steadily if not rapidly these years, perhaps more significantly with small farms such as this one (40 acres), however the income has fluctuated and continues to do so. Their income is adversely affected by many negative environmental factors, increasing inflation and a declining economy. Since I have a set income, and they have difficult times (i.e. inopportune excessive rain, frost, hail, mold & insect damage, etc.) I ask them only for the amount needed to pay my financial obligations as previously mentioned. In 1978, less money was requested due to severe crop damage from hail.

Petitioner testified at trial and did not dispute the authenticity of this letter. We therefore find this letter, standing alone, to be an admission by petitioner that she engaged in the operation of the farm primarily to provide her parents with a steady income and to obtain tax deductions rather than to make an economic profit. We also emphasize that petitioners state in their brief that petitioner's "primary motive was to provide a farm for her father and mother to enable them to become self-sufficient."

The terms of the oral agreement between petitioner and her father confirm petitioner's admission that she did not engage in the operation of her farm with the primary objective of making a profit. Pursuant to this agreement, petitioner was to receive farm income only to the extent of her farm expenses. Thus, regardless of the farm's profitability, petitioner would never realize a profit from the farm's operation. We also observe that during the years in issue, even though the farm produced sufficient income to cover petitioner's share of the farm expenses, she did not even receive all of the income to which she was entitled, but rather ceded some of her share to her father.

Petitioners argue that the farm was operated in a businesslike manner, that the farm was not used for personal pleasure or recreation, and that the farm losses were attributable to factors beyond petitioner's control. While under the regulations these are relevant factors to be considered in determining profit motive, they are rendered immaterial in this case in light of petitioner's admission that she did not have a profit objective. See sec. 1.183-2(b) Income Tax Regs. (some of the relevant factors listed which are to be considered in determining whether an activity is engaged in for profit).

Frazier v. Commissioner, T.C. Memo. 1985-61, does not require a different result. There, although the taxpayer's mother resided on the farm, the taxpayer, himself, nevertheless had a profit objective in operating the farm, which is not the case here.

There remains the question of interest and property taxes on the farm, allegedly paid by petitioners, which if substantiated would be deductible personal expenses even if petitioner's farm activity were not engaged in for profit. Sec. 183(b)(1). Respondent at trial challenged these deductions based on lack of substantiation. The expenses in question were not disallowed in the deficiency notice and disallowance has not been affirmatively pleaded by respondent in his answer or by an amended answer. Interest and property taxes on the farm will therefore be allowed to the extent claimed on petitioners' returns.

The deficiency notice determines an addition to tax for negligence under section 6653(a). Respondent has not pursued the matter in this proceeding and we presume that it has been abandoned. The additions to tax for negligence will not be imposed.

To reflect the foregoing,

Decision will be entered under Rule 155.

GULF OIL CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22499-82. Filed July 21, 1986.

Petitioner acquired undivided interests in oil and gas leases located in the Gulf of Mexico before and during the taxable years at issue. Delay rentals were paid within each of the taxable years at issue. These payments allowed Gulf to drill, explore, and produce minerals from any portion of the lease. Petitioner claimed "abandonments and extraordinary retirements" as to the leases in the Gulf of Mexico on its Federal tax returns for the taxable years 1974 and 1975 in the respective amounts of $35,651,455 and $108,108,366. The properties allegedly abandoned consisted of potential mineral

deposits within the leases and did not, in any instance, consist of an entire lease. *Held*, petitioner did not sustain a loss deductible under sec. 165, I.R.C. 1954, as it failed to evidence its intention to abandon the properties. *CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982), affg. on this issue *Brountas v. Commissioner*, 73 T.C. 491 (1979).

J. Waddy Bullion, *Emily A. Parker*, *Sean T. Crimmins*, *Buford P. Berry*, *J. Y. Robb III*, and *Margaret S. Alford*, for the petitioner.

Raymond L. Collins and *William B. Lowrance*, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax for the taxable year 1974 in the amount of $80,813,428 and for the taxable year 1975 in the amount of $166,316,320. Petitioner and respondent, by motion granted on November 10, 1983, agreed that certain issues would be severed and tried at a special trial session, which was held at Dallas, Texas.

One of the group of issues tried was designated by the parties as "Worthless Properties." The issues included are: (1) Whether certain of Gulf's interests in offshore leases were abandoned in the taxable years at issue, thereby giving rise to deductions under section 165;[1] and (2) if such deduction is established, the amount of Gulf's basis in each lease (lease bonus plus geological and geophysical costs, where appropriate) which is properly allocable to such worthless operating mineral interests.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Gulf Oil Corp. (hereinafter referred to as petitioner or Gulf) is a corporation organized under the laws of the Commonwealth of Pennsylvania with its principal office in Pittsburgh, Pennsylvania. During the taxable years 1974 and 1975, Gulf and certain of its subsidiary corporations constituted an "affiliated group" as that term is defined in section 1504. Petitioner, directly and through its foreign subsidiaries and affiliates, is engaged in world-wide exploration, development, production, purchase, and transportation of crude oil and natural gas, and in the manufacture, transportation, and marketing of petroleum products.

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[1] All section references are to the Internal Revenue Code of 1954, and attendant regulations as amended and in effect for the relevant years, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner maintained its books of account for the taxable years 1974 and 1975 on the accrual method of accounting using the calendar year as its taxable year. Gulf, as the common parent of an affiliated group of corporations, timely filed consolidated Federal income tax returns for its taxable years 1974 and 1975 on behalf of itself, and certain of its subsidiary corporations, with the Office of the Internal Revenue Service at Pittsburgh, Pennsylvania. On its consolidated corporate tax returns for the taxable years 1974 and 1975, Gulf claimed "abandonments and extraordinary retirements" with respect to properties in the Gulf of Mexico in the amounts of $35,561,455 and $108,108,366, respectively.

The properties at issue are blocks of land in the Gulf of Mexico that have been leased from either the United States or Louisiana because of the value of the underground minerals. The geology of the area varies. A large cenozoic basin covers much of the coastal area of onshore Texas and all of the offshore Texas and Louisiana areas. This cenozoic basin is surrounded by a series of mesozoic basins, which range from the Rio Grande embayment near the Texas-Mexican border, to the East Texas basin north of the Sabine uplift in East Texas, to the Mississippi interior basin, which includes much of southern Mississippi and much of northern Louisiana, and to the eastern part of the Gulf of Mexico and peninsular Florida. The cenozoic basin containing the offshore Louisiana area is much younger and very different structurally from the older mesozoic basins such as the mesozoic basin in the eastern part of the Gulf of Mexico. The main geologic difference between the offshore Louisiana area and the eastern Gulf of Mexico is that in offshore Louisiana there are many thousands of feet of porous potentially hydrocarbon-bearing sands (hereinafter referred to as mineral deposits) alternating with shale, whereas in the eastern Gulf of Mexico the porous sections that have the potential of containing oil and gas reservoirs are not very numerous but are more concentrated.

To reflect the different underlying geology and potential for mineral production, the Gulf of Mexico is divided by petitioner into a number of "areas." Two such offshore areas are the offshore Louisiana area and the MAFLA offshore area. The offshore Louisiana area is, as the name implies, located off the coast of Louisiana. MAFLA is an acronym for Mississippi, Alabama, and Florida. The MAFLA offshore area is located in the eastern Gulf of Mexico adjacent to these three States. The properties at issue are contained within one or the other of these two areas as detailed below.

Gulf was one of the first companies to explore for oil and gas in the Gulf of Mexico, beginning in the early 1950's. The Gulf of Mexico has been one of the primary exploration areas for Gulf throughout the company's history. Gulf has enjoyed considerable success in its Gulf of Mexico drilling and exploration program conducted within leases of land containing mineral deposits. By 1972, the offshore Louisiana area of the Gulf of Mexico had been the subject of extensive exploration by petroleum companies such as Gulf. Substantial exploration and drilling in the area resulted in the discovery and development of many oil and gas fields. Thus, bidders on new leases in the offshore Louisiana area had production history and geologic control data available to them.

In contrast to the offshore Louisiana area, the MAFLA offshore area was not a developed area immediately prior to the taxable years in issue. The first offshore lease sale in the MAFLA offshore area occurred on December 20, 1973. Prior to that time there had been no opportunity to drill any wells in the area.

All of the leases at issue but West Delta 109, which was obtained from the State of Louisiana, were leased from the Minerals Management Service, which is a Federal agency that administers the granting, development, operation, and surrender of oil and gas leases granted by the United States of America. More particularly, the Minerals Management Service is responsible for leasing and for management of operations offshore in the Gulf of Mexico. When the

Minerals Management Service offered a list of outer continental shelf blocks that were available for leasing, Gulf assigned the block list to the geophysical section of the company. The geophysical section then prepared a structure map showing the potential deposits that might be contained in the block. In the offshore Louisiana area, it was often possible to use a nearby producing field as an analogue by which Gulf could readily determine the probability of producible oil or gas. In the MAFLA offshore area, it was generally necessary for Gulf to look onshore in order to find analogues, which could be used to determine the potential mineral deposits in the block offered for lease. The structure map of potential deposits was turned over to the geological section of the company, which estimated the potential mineral reserves of each of the potential deposits.

To determine how much it would bid for an offshore lease, Gulf started with the basic geologic evaluation, which would allow the estimation of the amount of oil or gas present in the block of land to be leased. Gulf then estimated potential costs for drilling exploratory wells, drilling and completing development wells, and placing the lease into production. Gulf developed a series of geological maps which were turned over to the reservoir engineers for a recommendation as to the bid Gulf should pay for the block in light of the rate of return on investment that Gulf required. The requisite rate of return varied according to the risk of the prospect. The single most important factor in determining how much to bid for an offshore lease was the geologic assessment of risk. For example, for two potential 100-million-barrel prospects, Gulf might be willing to pay $1 million for one which has a low degree of risk and $50 million for the other which has a higher degree of risk. Risk was primarily determined by Gulf's geologists. The final calculation of the amount of Gulf's bid was predicated on an assessment of that risk in light of the data it had accumulated.

The outer continental shelf leases covered only a portion of the Gulf of Mexico and are numbered using the prefix "OCS-G." Additional leases were available from the State of Louisiana under the same procedures as the outer continental shelf leases. Gulf made a geologic evaluation to determine the potential mineral deposits present and then submitted a bid to the State of Louisiana.

Gulf acquired undivided interests in 23 oil and gas leases located in the offshore Louisiana area and in the MAFLA offshore area, covering the indicated blocks in the designated offshore areas as of the specified effective dates:

OFFSHORE LOUISIANA

Area	*Block*	*Lease*	*Date*	*Gulf's undivided interest*
East Cameron	236	OCS-G 2859	12/1/74	33.33334%
East Cameron	237	OCS-G 2860	12/1/74	33.33333
Garden Banks	326	OCS-G 2809	9/1/74	50
Grand Isle	88	OCS-G 2931	12/1/74	50
Main Pass	138	OSC-G 2191	10/1/72	40
Main Pass	146	OSC-G 2195	11/1/72	50
Ship Shoal	228	OSC-G 2333	2/1/73	50
West Delta	35-36	OSC-G 2165	10/1/72	70
West Delta	113	OCS-G 2169	11/1/72	50
West Delta	109	Louisiana State Lease No. 6309	5/8/74	30⅓

MAFLA OFFSHORE AREA

Area	*Block*	*Lease*	*Date*	*Gulf's undivided interest*
Destin Dome	122	OCS-G 2496	1/1/74	50%
Destin Dome	210	OCS-G 2483	1/1/74	25
Destin Dome	254	OCS-G 2476	1/1/74	50
Destin Dome	255	OCS-G 2477	1/1/74	33⅓
Destin Dome	359	OCS-G 2467	1/1/74	33⅓
Destin Dome	360	OCS-G 2468	1/1/74	100
Destin Dome	404	OCS-G 2465	1/1/74	50
Florida Middleground	252	OCS-G 2516	1/1/74	33⅓
St. Petersburg	99	OCS-G 2522	1/1/74	50
St. Petersburg	100	OCS-G 2523	1/1/74	25
Viosca Knoll	24	OCS-G 2460	1/1/74	50
Viosca Knoll	68	OCS-G 2454	1/1/74	33⅓
Viosca Knoll	74	OCS-G 2457	1/1/74	33⅓

Except for West Delta 109, the lessor for the leases identified above (hereinafter collectively referred to as the leases in question and individually referred to by area and block), was the United States of America. The lessor for West Delta 109 was the State of Louisiana. The primary term of each of the leases in question was 5 years from the effective date of the lease.

Gulf (together with the other co-owners of the leases in question), as a successful bidder for the leases in question, was required to pay a cash bonus for each such lease. The bonus costs of the leases in question were very high, averaging over $15 million per lease and ranging up to over $60 million for a single lease. The following chart shows the cash bonus paid for each of the leases in question and Gulf's share of such bonus:

OFFSHORE LOUISIANA

Lease area and block	*Bonus*	*Gulf's undivided interest*	*Gulf's share of bonus*[1]
East Cameron 236	$27,972,000.00	33.33334%	$9,324,002
East Cameron 237	6,933,000.00	33.33333	2,311,000
Garden Banks 326	1,790,000.00	50	895,000
Grand Isle 88	7,982,000.00	50	3,991,000
Main Pass 138	22,233,000.00	40	8,893,200
Main Pass 146	11,133,000.00	50	5,566,500
Ship Shoal 228	6,351,760.00	50	3,175,880
West Delta 35-36	41,400,000.00	70	28,980,000
West Delta 113	1,126,666.66	50	563,333
West Delta 109	7,713,000.00	33⅓	2,571,000

[1] Rounded to the nearest dollar.

MAFLA OFFSHORE AREA

Lease area and block	*Bonus*	*Gulf's undivided interest*	*Gulf's share of bonus*[1]
Destin Dome 122	$8,181,000	50%	$4,090,500
Destin Dome 210	61,166,000	25	15,291,500
Destin Dome 254	5,777,000	50	2,888,500
Destin Dome 255	11,566,000	33⅓	3,855,333
Destin Dome 359	8,111,000	33⅓	2,703,667
Destin Dome 360	36,067,000	100	36,067,000
Destin Dome 404	35,555,000	50	17,777,500
Florida Middleground 252	5,655,000	33⅓	1,885,000
St. Petersburg 99	6,166,000	33⅓	2,055,333
St. Petersburg 100	15,777,000	25	3,944,250
Viosca Knoll 24	13,731,000	50	6,865,500
Viosca Knoll 68	17,171,000	33⅓	5,723,667
Viosca Knoll 74	7,555,000	33⅓	2,518,333

[1] Rounded to the nearest dollar.

Except for West Delta 109, each of the leases in question, all of which covered an area of between 5,000 and 5,760 acres, provided for a yearly delay rental of $3 per acre, resulting in a yearly delay rental of less than $20,000 for each such lease. For West Delta 109 (the Louisiana State lease), the yearly delay rental was one-half of the bonus payment, resulting in a yearly delay rental of approximately $3,856,500 for the lease. Gulf paid delay rentals to the Minerals Management Service or the State of Louisiana for each of the leases during the taxable year at issue. Throughout the taxable years at issue, Gulf felt that each of the leases had the potential of containing at least one mineral deposit with commercial value. Payment of the delay rentals caused ownership of the leases to be retained throughout the primary term and allowed Gulf to complete its exploration of the leased property.

At or shortly after the time that Gulf acquired its interest in each of the leases in question, it made a determination of the potential mineral deposits that, in its opinion, were contained in each such lease. The following chart shows the number of potential mineral deposits, as determined by Gulf with respect to each such lease, and the horizontal intervals within which such potential mineral deposits were located. Gulf determined such mineral deposits no later than the date shown in parentheses with respect to each lease. The mineral deposits as determined by Gulf are labeled D1, D2, D3, and so on, in order of increasing depth.

OFFSHORE LOUISIANA

Lease area and block	*Depth interval (in feet)*	*Potential deposits*
East Cameron 236	6,000- 7,000	3 (D1, D2, D3)
(Dec. 6, 1974)	7,000- 8,000	3 (D4, D5, D6)
	8,000- 9,000	2 (D7, D8)
	9,000-10,000	4 (D9, D10, D11, D12)
	10,000-11,000	2 (D13, D14)
	11,000-12,000	2 (D15, D16)
	12,000-13,000	2 (D17, D18)
	13,000-14,000	1 (D19)
	Total	19
East Cameron 237	6,000- 7,000	3 (D1, D2, D3)
(Dec. 6, 1974)	7,000- 8,000	3 (D4, D5, D6)
	8,000- 9,000	2 (D7, D8)

Lease area and block	*Depth interval (in feet)*	*Potential deposits*
	9,000-10,000	4 (D9, D10, D11, D12)
	10,000-11,000	2 (D13, D14)
	11,000-12,000	2 (D15, D16)
	12,000-13,000	2 (D17, D18)
	13,000-14,000	1 (D19)
	Total	19
Garden Banks 326 (Dec. 6, 1974)	3,000- 4,000	2 (D1, D2)
	4,000- 5,000	2 (D3, D4)
	5,000- 6,000	2 (D5, D6)
	Total	6
Grand Isle 88 (Dec. 6, 1974)	6,000- 7,000	7 (D1, D2, D3, D4, D5, D6, D7)
	7,000- 8,000	5 (D8, D9, D10, D11, D12)
	8,000- 9,000	6 (D13, D14, D15, D16, D17, D18)
	9,000-10,000	4 (D19, D20, D21, D22)
	10,000-11,000	5 (D23, D24, D25, D26, D27)
	11,000-12,000	5 (D28, D29, D30, D31, D32)
	12,000-13,000	4 (D33, D34, D35, D36)
	13,000-14,000	3 (D37, D38, D39)
	Total	39
Main Pass 138 (Dec. 15, 1972)	5,000- 6,000	12 (D1, D2, D3, D4, D5, D6, D7, D8, D9, D10 D11, D12)
	6,000- 7,000	11 (D13, D14, D15, D16, D17, D18, D19, D20, D21, D22, D23)
	7,000- 8,000	8 (D24, D25, D26, D27, D28, D29, D30, D31)
	8,000- 9,000	4 (D32, D33, D34, D35)
	9,000- 9,500	1 (D36)
	Total	36
Main Pass 146 (Dec. 15, 1972)	5,000- 6,000	12 (D1, D2, D3, D4, D5, D6, D7, D8, D9, D10, D11, D12)
	6,000- 7,000	11 (D13, D14, D15, D16, D17, D18, D19, D20, D21, D22, D23)
	7,000- 8,000	8 (D24, D25, D26, D27, D28, D29, D30, D31)
	8,000- 9,000	4 (D32, D33, D34, D35)
	9,000- 9,500	1 (D36)
	Total	36

Lease area and block	*Depth interval (in feet)*	*Potential deposits*
Ship Shoal 228	5,000- 6,000	2 (D1, D2)
(Jan. 19, 1973)	6,000- 7,000	0
	7,000- 8,000	1 (D3)
	8,000- 9,000	1 (D4)
	9,000-10,000	2 (D5, D6)
	10,000-11,000	0
	11,000-12,000	0
	12,000-13,000	0
	13,000-14,000	1 (D7)
	14,000-15,000	1 (D8)
	15,000-16,000	2 (D9, D10)
	Total	10
West Delta 35-36	8,000- 9,000	1 (D1)
(Dec. 15, 1972)	9,000-13,000	2 (D2, D3)
	13,000-14,000	4 (D4, D5, D6, D7)
	14,000-15,000	4 (D8, D9, D10, D11)
	15,000-16,000	4 (D12, D13, D14, D15)
	16,000-17,500	3 (D16, D17, D18)
	Total	18
West Delta 113	7,500- 8,500	5 (D1, D2, D3, D4, D5)
(Dec. 15, 1972)		
	8,500- 9,500	7 (D6, D7, D8, D9, D10, D11, D12)
	9,500-10,500	6 (D13, D14, D15, D16, D17, D18)
	10,500-11,500	6 (D19, D20, D21, D22, D23, D24)
	11,500-12,500	7 (D25, D26, D27, D28, D29, D30, D31)
	12,500-13,500	6 (D32, D33, D34, D35, D36, D37)
	Total	37
West Delta 109	3,000- 4,000	1 (D1)
(Oct. 27, 1974)	4,000- 5,000	3 (D2, D3, D4)
	5,000- 6,000	3 (D5, D6, D7)
	6,000- 7,000	3 (D8, D9, D10)
	7,000- 8,000	4 (D11, D12, D13, D14)
	8,000- 9,000	5 (D15, D16, D17, D18, D19)
	9,000-10,000	2 (D20, D21)
	10,000-11,000	4 (D22, D23, D24, D25)
	11,000-12,000	4 (D26, D27, D28, D29)
	12,000-13,000	4 (D30, D31, D32, D33)
	13,000-14,000	1 (D34)
	14,000-15,000	1 (D35)
	Total	35

MAFLA OFFSHORE AREA

Lease area and block	*Depth interval (in feet)*	*Potential deposits*
Destin Dome 122	3,500- 6,000	3 (D1, D2, D3)
(Feb. 20, 1974)	6,000-15,700	3 (D4, D5, D6)
	15,700-18,500	2 (D7, D8)
	Total	8
Destin Dome 210	3,500- 6,000	3 (D1, D2, D3)
(Feb. 20, 1974)	6,000-15,700	3 (D4, D5, D6)
	15,700-18,500	2 (D7, D8)
	Total	8
Destin Dome 254	3,500- 6,000	3 (D1, D2, D3)
(Feb. 20, 1974)	6,000-15,700	3 (D4, D5, D6)
	15,700-18,500	2 (D7, D8)
	Total	8
Destin Dome 255	3,500- 6,000	3 (D1, D2, D3)
(Feb. 20, 1974)	6,000-15,700	3 (D4, D5, D6)
	15,700-18,500	2 (D7, D8)
	Total	8
Destin Dome 359	8,000- 8,500	2 (D1, D2)
(Feb. 20, 1974)	8,500-17,000	4 (D3, D4, D5, D6)
	Total	6
Destin Dome 360	8,000- 8,500	2 (D1, D2)
(Feb. 20, 1974)	8,500-17,000	4 (D3, D4, D5, D6)
	Total	6
Destin Dome 404	8,000- 8,500	2 (D1, D2)
(Feb. 20, 1974)	8,500-17,000	4 (D3, D4, D5, D6)
	Total	6
Florida	3,000- 5,600	1 (D1)
Middleground 252	5,600-13,400	1 (D2)
(Feb. 20, 1974)	13,400-14,000	1 (D3)
	Total	3
St. Petersburg 99	6,500- 7,300	1 (D1)
(Feb. 20, 1974)	7,300-16,000	1 (D2)
	16,000-18,000	1 (D3)
	Total	3
St. Petersburg 100	6,500- 7,300	1 (D1)
(Feb. 20, 1974)	7,300-16,000	1 (D2)
	16,000-18,000	1 (D3)
	Total	3
Viosca Knoll 24	4,000- 5,000	1 (D1)
(Feb. 20, 1974)	5,000- 6,000	1 (D2)
	6,000- 7,200	1 (D3)
	7,200-20,000	1 (D4)
	Total	4
Viosca Knoll 68	4,000- 5,000	1 (D1
(Feb. 20, 1974)	5,000- 6,000	1 (D2)

Lease area and block	Depth interval (in feet)	Potential deposits
	6,000- 7,200	1 (D3)
	7,200-20,000	1 (D4)
	Total	4
Viosca Knoll 74 (Feb. 20, 1974)	3,000- 4,000	1 (D1)
	4,000- 5,000	1 (D2)
	5,000- 6,500	1 (D3)
	6,500-20,000	1 (D4)
	Total	4

Gulf made an election under section 614(b)(2) to treat each of the potential mineral deposits as an operating mineral interest and as a separate property.[2]

Gulf allocated its basis (composed of the bonus payment plus geological and geophysical costs in each lease, where appropriate) to and among the mineral deposits that Gulf, in its opinion, had determined were contained in such lease. Each mineral deposit anticipated by Gulf to be within each lease located off the shore of Louisiana was allocated an identical percentage and amount of Gulf's basis in the particular lease. The number of potential mineral deposits as determined by Gulf to be within each lease off the shore of Louisiana, the percentage and amount of Gulf's basis in the underlying lease allocated to the mineral deposits, and the date of the allocations, are as follows:

OFFSHORE LOUISIANA

Lease area and block	Potential deposits	Percentage of basis	Amount of basis[1]
East Cameron 236 (Dec. 6, 1974)	19	$5\frac{5}{19}$%	$490,737
East Cameron 237 (Dec. 6, 1974)	19	$5\frac{5}{19}$	121,632
Garden Banks 326 (Feb. 20, 1974)	6	$16\frac{4}{6}$	149,167
Grand Isle 88 (Dec. 6, 1974)	39	$2\frac{22}{39}$	102,333
Main Pass 138 (Dec. 15, 1972)	36	$2\frac{7}{9}$	247,033
Main Pass 146	36	$2\frac{7}{9}$	154,625

(Footnote at end of table.)

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[2] The parties stipulated that petitioner elected this treatment of the potential mineral deposits contained in the horizontal strata of each lease. No evidence of such an election is contained within petitioner's returns for the taxable years 1974 or 1975.

Lease area and block	*Potential deposits*	*Percentage of basis*	*Amount of basis*[1]
(Dec. 15, 1972)			
Ship Shoal 228 (Jan. 19, 1973)	10	10%	$329,035
West Delta 35-36 (Dec. 15, 1972)	18	$5\frac{5}{9}$	1,610,200
West Delta 113 (Dec. 15, 1972)	37	$2\frac{26}{37}$	15,225
West Delta 109 (Dec. 15, 1972)	35	$2\frac{6}{7}$	74,247

[1] Rounded to the nearest dollar.

In contrast, the potential mineral deposits within the MAFLA offshore area leases were valued according to relative estimated value. This unequal allocation was felt to be more appropriate due to the uneven distribution of the deposits and greater potential reserves within the deposits. The percentage and amount of petitioner's basis in each of the leases located in the MAFLA offshore area that Gulf allocated to each of the potential mineral deposits within the horizontal strata, and the date of such allocation, are:

Lease area and block		*Potential deposits*	*Percentage of basis*	*Amount of basis*[1]
Destin Dome 122		D1	5%	$204,525
(Feb. 20, 1974)		D2	5	204,525
		D3	30	1,227,150
		D4	5	2 04,525
		D5	10	409,050
		D6	5	204,525
		D7	30	1,227,150
		D8	10	409,050
	Total	8	100	4,090,500
Destin Dome 210		D1	5	$764,575
(Feb. 20, 1974)		D2	5	764,575
		D3	30	4,587,450
		D4	5	764,575
		D5	10	1,529,150
		D6	5	764,575
		D7	30	4,587,450
		D8	10	1,529,150
	Total	8	100	15,291,500
Destin Dome 254		D1	5	$144,425
(Feb. 20, 1974)		D2	5	144,425
		D3	30	866,550

(Footnotes at end of table.)

Lease area and block		*Potential deposits*	*Percentage of basis*	*Amount of basis*[1]
		D4	5%	$144,425
		D5	10	288,850
		D6	5	866,550
		D7	30	866,550
		D8	10	288,850
	Total	8	100	[2]3,610,625
Destin Dome 255 (Feb. 20, 1974)		D1	5	192,767
		D2	5	192,767
		D3	30	1,156,600
		D4	5	192,767
		D5	10	385,533
		D6	5	192,767
		D7	30	1,156,600
		D8	10	385,533
	Total	8	100	3,855,334
Destin Dome 359 (Feb. 20, 1974)		D1	3	81,110
		D2	7	189,257
		D3	5	135,183
		D4	5	135,183
		D5	50	1,351,833
		D6	30	811,100
	Total	6	100	2,703,666
Destin Dome 360 (Feb. 20, 1974)		D1	10	3,606,700
		D2	20	7,213,400
		D3	10	3,606,700
		D4	10	3,606,700
		D5	30	10,820,100
		D6	20	7,213,400
	Total	6	100	36,067,000
Destin Dome 404 (Feb. 20, 1974)		D1	5	888,875
		D2	15	2,666,625
		D3	5	888,875
		D4	5	888,875
		D5	45	7,999,875
		D6	25	4,444,375
	Total	6	100	17,777,500
Florida Middleground 252 (Feb. 20, 1974)		D1	25	471,250
		D2	50	942,500
		D3	25	471,250
	Total	3	100	1,885,000
St. Petersburg 99 (Feb. 20, 1974)		D1	25	513,833
		D2	50	1,027,667
		D3	25	513,833
	Total	3	100	2,055,333

Footnotes at end of table.

Lease area and block		*Potential deposits*	*Percentage of basis*	*Amount of basis*[1]
St. Petersburg 100 (Feb. 20, 1974)		D1	25%	$986,063
		D2	50	1,972,125
		D3	25	986,063
	Total	3	100	3,944,251
Viosca Knoll 24 (Feb. 20, 1984)		D1	5	359,872
		D2	80	5,534,259
		D3	5	359,873
		D4	10	705,021
	Total	4	100	6,959,025
Viosca Knoll 68 (Feb. 20, 1974)		D1	5	297,154
		D2	80	4,607,216
		D3	5	297,156
		D4	10	584,491
	Total	4	100	5,786,017
Viosca Knoll 74 (Feb. 20, 1974)		D1	5	125,917
		D2	80	2,014,667
		D3	5	125,917
		D4	10	251,833
	Total	4	100	2,518,334

[1] Rounded to the nearest dollar.

[2] Although this figure differs from the total basis stipulated for Destin Dome 254, in the amount of $2,888,500, the stipulated figure is clearly a clerical error.

The following chart shows wells that were drilled upon the leases in question or upon other leases during or prior to the taxable years in issue, the lease upon which each well was drilled, the date each well was spudded, the total depth of each well, and the date upon which such well was plugged and abandoned. Gulf participated in the drilling of each of the wells shown in the chart other than MO 996 MOBIL #1.

Well	*Lease drilled*	*Spud date*	*Total depth (in feet)*	*Date plugged and abandoned*
DD 166 SUN #1	[1]OCS-G 2490	10/24/74	17,608	3/06/75
DD 360 GULF #1	OCS-G 2468	4/21/75	20,988	10/02/75
EC 236 PENZOIL #1	OCS-G 2859	12/22/74	13,500	2/04/75
FM 252 TEXACO #1	OCS-G 2516	9/22/74	15,660	1/26/75
GB 326 GULF #1	OCS-G 2809	8/03/75	1,616	8/08/75
GB 326 GULF #2	OCS-G 2809	8/10/75	6,738	9/14/75
GI 88 GULF #1	OCS-G 2931	4/14/75	12,505	7/02/75
MO 996 MOBIL #1	[1]OCS-G 2442	8/03/74	5,705	9/13/74
MP 138 GULF #1	OCS-G 2191	10/31/72	7,976	11/26/72
MP 138 GULF #2	OCS-G 2191	11/26/72	7,510	12/10/72
MP 138 GULF #3	OCS-G 2191	12/25/72	9,500	1/19/73
MP 138 GULF #4	OCS-G 2191	1/20/73	7,500	2/02/73

(Footnotes at end of table.)

Well	*Lease drilled*	*Spud date*	*Total depth (in feet)*	*Date plugged and abandoned*
PM 138 SKELLY #5	OCS-G 2191	5/04/75	11,347	6/12/75
MP 146 GULF #B-9	[1]OCS-G 2195	12/20/73	12,975	6/19/74
SP 100 TEXACO #1	OCS-G 2523	1/27/75	17,388	5/26/75
SS 228 CHEVRON #1	OCS-G 2333	3/11/74	16,000	5/06/74
VK 23 CHEVRON #1	[1]OCS-G 2459	7/24/74	6,039	8/20/74
VK 23 CHEVRON #2	OCS-G 2459	8/07/74[2]	N/A	11/25/75[3]
WD 35-36 GULF #1	OCS-G 2165	10/20/72	17,000	2/19/73
WD 35-36 GULF #2	OCS-G 2165	8/14/73	15,700	(4)
WD 35-36 GULF #3	OCS-G 2165	11/20/73	16,065	(5)
WD 35-36 GULF #4	OCS-G 2165	2/06/74	15,467	(6)
WD 109 CHEVRON #1	LA #6309	6/15/74	14,000	8/06/74
WD 109 CHEVRON #2	LA #6309	4/25/75	13,050	6/21/75
WD 113 GULF #1	OCS-G 2169	7/05/75	11,500	7/27/75

[1] Not one of the leases in question.
[2] Well located on this date, but well was never spudded.
[3] Well abandoned prior to drilling.
[4] Suspended 11/18/73; completed 11/14/74 as Dry Gas well.
[5] Suspended 2/5/74; completed 11/20/74 as Dual Dry Gas well.
[6] Suspended 3/31/74; completed 11/17/74 as Dry Gas well.

The following are the potential mineral deposits contained within the leases in question that were identified by petitioner as separate operating mineral interests, for which Gulf claimed deductions on the grounds that they became worthless in 1974; the depth of the well or wells that were drilled upon the leases in question or upon other leases; and the amount of the deductions claimed on petitioner's return for the taxable years 1974:

OFFSHORE LOUISIANA

Lease area and block: Ship Shoal 228
Deposits for which deductions claimed: D1 through D6
Well: SS 228 CHEVRON #1 (Total depth: 16,000')
Deductions claimed (1974): $1,974,169

Lease area and block: West Delta 35-36
Deposits for which deductions claimed: D6 through D18
Well: WD 35-36 GULF #1 (Total depth: 17,000')
WD 35-36 GULF #2 (Total depth: 15,700')
WD 35-36 GULF #3 (Total depth: 16,065')
WD 35-36 GULF #4 (Total depth: 15,467')
Deductions claimed (1974): $20,932,600

Lease area and block: West Delta 109
Deposits for which deductions claimed: Dl through D25

Well: WD 109 CHEVRON #1 (Total depth: 14,000')
WD 109 CHEVRON #2 (Total depth: 13,050')
Deductions claimed (1974): $1,856,184

MAFLA OFFSHORE AREA

Lease area and block: Viosca Knoll 24
Deposits for which deductions claimed: D1 and D2
Well: VK 23 CHEVRON #1 (Total depth: 6,039')
Deductions claimed (1974): $5,894,131

Lease area and block: Viosca Knoll 68
Deposits for which deductions claimed: D1 and D2
Well: VK 23 CHEVRON #1 (Total depth: 6,039')
Deductions claimed (1974): $4,904,371

TOTAL DEDUCTIONS CLAIMED (1974): $35,561,455

The following are the potential mineral deposits contained within the leases in question that were identified by petitioner as separate operating mineral interests, for which Gulf claimed deductions on the grounds that they became worthless in 1975; the depth of well or wells that were drilled upon the leases in question or upon other leases; and the amount of the deductions claimed on petitioner's return for the taxable year 1975:

OFFSHORE LOUISIANA

Lease area and block: East Cameron 236
Deposits for which deductions claimed: D1, D3 through D9, D11, D12, and D16 through D19
Well: EC 236 PENZOIL #1 (Total depth: 13,500')
deductions claimed (1975): $6,870,317

Lease area and block: East Cameron 237
Deposits for which deductions claimed: D1 through D18
Well: EC 236 PENZOIL #1 (Total depth: 13,500')
Deductions claimed (1975): $2,189,368

Lease area and block: Garden Banks 326
Deposits for which deductions claimed: D1 through D5
Well: GB 326 GULF #1 (Total depth: 1,616')
GB 326 GULF #2 (Total depth: 6,738')
Deductions claimed (1975): $745,833

Lease area and block: Grand Isle 88
Deposits for which deductions claimed: D5 through D39
Well: GI 88 GULF #1 (Total depth: 12,505')
Deductions claimed (1975): $3,581,667

Lease area and block: Main Pass 138
Deposits for which deductions claimed: D4 through D31, and D33 through D35

Well: MP 138 GULF #1 (Total depth: 7,976')
MP 138 GULF #2 (Total depth: 7,510')
MP 138 GULF #3 (Total depth: 9,500')
MP 138 GULF #4 (Total depth: 7,500')
MP 138 SKELLY #5 (Total depth: 11,347')
Deductions claimed (1975): $7,658,033

Lease area and block: Main Pass 146
Deposits for which deductions claimed: D5 through D36
Well: MP 146 GULF #B-9 (Total depth: 12,975')
Deductions claimed (1975): $4,948,000

Lease area and block: West Delta 113
Deposits for which deductions claimed: D2 through D37
Well: WD 113 GULF #1 (Total depth: 11,500')
Deductions claimed (1975): $548,108

MAFLA OFFSHORE AREA

Lease area and block: Destin Dome 122
Deposits for which deductions claimed: D1 through D7
Well: DD 166 SUN #1 (Total depth: 17,608')
Deductions claimed (1975): $3,681,450

Lease area and block: Destin Dome 210
Deposits for which deductions claimed: D1 through D7
Well: DD 166 SUN #1 (Total depth: 17,608')
Deductions claimed (1975): $13,762,350

Lease area and block: Destin Dome 254
Deposits for which deductions claimed: D1 through D7
Well: DD 166 SUN #1 (Total depth: 17,608')
Deductions claimed (1975): $2,599,650

Lease area and block: Destin Dome 255
Deposits for which deductions claimed: D1 through D7
Well: DD 166 SUN #1 (Total depth: 17,608')
Deductions claimed (1975): $3,469,800

Lease area and block: Destin Dome 359
Deposits for which deductions claimed: D2 through D6
Well: DD 360 GULF #1 (Total depth: 20,988')
Deductions claimed (1975): $2,621,990

Lease area and block: Destin Dome 360
Deposits for which deductions claimed: D2 through D6
Well: DD 360 GULF #1 (Total depth: 20,988')
Deductions claimed (1975): $32,460,300

Lease area and block: Destin Dome 404
Deposits for which deductions claimed: D2 through D6
Well: DD 360 GULF #1 (Total depth: 20,988')
Deductions claimed (1975): $16,888,625

Lease area and block: Florida Middleground 252
Deposits for which deductions claimed: D1 and D3
Well: FM 252 TEXACO #1 (Total depth: 15,660')

eductions claimed (1975): $942,500

ease area and block: St. Petersburg 99
eposits for which deductions claimed: D1 and D3
Vell: SP 100 TEXACO #1 (Total depth: 17,388')
eductions claimed (1975): $1,027,666

ease area and block: St. Petersburg 100
eposits for which deductions claimed: D1 and D3
Vell: SP 100 TEXACO #1 (Total depth: 17,388')
eductions claimed (1975): $1,972,125

ease area and block: Viosca Knoll 74
eposits for which deductions claimed: D1 and D2
Vell: MO 996 MOBIL #1 (Total depth: 5,705')
eductions claimed (1975): $2,140,584

OTAL DEDUCTIONS CLAIMED (1975): $108,108,366

Without production in paying quantities or continuation
f drilling, each lease at issue would have automatically
xpired at the end of its 5-year primary term. When an
ffshore lease expired by operation of law, the Minerals
Ianagement Service recorded that fact and the lease then
ecame available for bid at a subsequent lease sale. In
ddition to expiration of a lease by operation of law, the
Iinerals Management Service also accepted the release or
elinquishment of offshore leases, but only pursuant to its
egulations. The Minerals Management Service accepted
elinquishment of an entire offshore lease or an "officially
esignated subdivision" thereof, but did not accept relin-
uishment of a horizontal interval, strata, or sands in an
ffshore lease since such a horizontal division did not
onstitute an "officially designated subdivision" of an
ffshore lease. For example, the Minerals Management
ervice would not have accepted relinquishment of an
ffshore lease where the relinquishment was limited to all
epths below 5,000 feet. The refusal of Minerals Manag-
ent Service to accept relinquishment of a lessee's interest
a horizontal interval in an offshore lease was based upon
egulations that had been in effect since 1954.

Subsequent to the taxable years in issue, Gulf filed a
elinquishment of all of its interest for each of the leases in
uestion (except for East Cameron 237, which is presently
production). The following chart shows the date upon
hich Gulf filed its relinquishment of all of its interest in
ach lease, the effective date of the cancellation of the lease

(or the date the lease expired, if so indicated), and the date upon which the primary term of the lease expired or would have expired but for such relinquishment or the extension of the lease by production:

OFFSHORE LOUISIANA

Lease area and block	*Date relinquishment filed*	*Date lease canceled*	*Date lease primary term did or would have expired*
East Cameron 236	01/31/80	11/30/79[1]	11/30/79
East Cameron 237	See (2) below	See (2) below	11/30/79
Garden Banks 326	08/27/79	08/27/79	08/31/79
Grand Isle 88	11/30/79	11/30/79[1]	11/30/79
Main Pass 138	10/03/77	09/30/77[1]	09/30/77
Main Pass 146	10/28/77	10/28/77	10/31/77
Ship Shoal 228	08/16/78	03/05/78[1]	03/05/78
West Delta 35-36	05/05/83	02/17/83[1]	09/30/77
West Delta 109	See (3) below	See (3) below	05/07/79
West Delta 113	10/26/76	10/26/76	10/31/77

[1] Lease expired by its own terms.

[2] The lease is presently active, so no relinquishment has been filed and the lease has not been canceled.

[3] Exact dates that relinquishment was filed and lease was canceled are not known. Relinquishment was executed June 21, 1976.

MAFLA OFFSHORE AREA

Lease area and block	*Date relinquishment filed*	*Date lease canceled*	*Date lease primary term did or would have expired*
Destin Dome 122	12/21/78	12/21/78	12/31/78
Destin Dome 210	03/12/79	12/31/78[1]	12/31/78
Destin Dome 254	12/21/78	12/21/78	12/31/78
Destin Dome 255	12/21/78	12/21/78	12/31/78
Destin Dome 359	12/21/78	12/21/78	12/31/78
Destin Dome 360	12/21/78	12/21/78	12/31/78
Destin Dome 404	12/21/78	12/21/78	12/31/78
Florida Middleground 252	12/27/76	12/27/76	12/31/78
St. Petersburg 99	12/17/76	12/17/76	12/31/78
St. Petersburg 100	12/27/76	12/27/76	12/31/78
Viosca Knoll 24	12/21/78	12/21/78	12/31/78
Viosca Knoll 68	12/21/78	12/21/78	12/31/78
Viosca Knoll 74	12/21/78	12/21/78	12/31/78

[1] Lease expired by its own terms.

Gulf's tax department initiated the process that led to the establishment of Gulf's separate property procedures in the Gulf of Mexico. In August and December of 1975, Gulf employees exchanged memoranda clarifying whether percentages or fractions of deposits were to be written off. The abandonment losses to be claimed on petitioner's return for the taxable year 1975 were acknowledged in these memoranda to be independent of actual relinquishment of the leases. The writeoffs of mineral deposits within horizontal strata were solely for tax purposes and each of the leases continued to be maintained on the books of Gulf Oil. Gulf did not inform any person other than its employees of its determination that the mineral deposits were worthless or of their alleged abandonment. Petitioner's returns for the taxable years 1974 and 1975 reflect abandonment losses in bulk without disclosure of the fact that only portions of leases were being deducted as losses sustained due to worthlessness.

Gulf did not dispose of any of the undivided interests that it had acquired in the leases in question by sale, exchange, sublease, or any other form of disposition, during the taxable years in issue. Gulf farmed out limited rights in the leases on East Cameron 237 and in the West Delta 35 and 36 leases. Gulf did not inform the farmees that it had "abandoned" portions of the leases, nor did Gulf disclaim any interest in any of the depth intervals that were farmed out, even though portions of some of these strata had allegedly been written off as worthless and abandoned. Petitioner paid a portion of the development costs as to the farmed-out strata in which mineral deposits were discovered, and also claimed production from a deposit in one strata that it had earlier claimed to have abandoned.

Petitioner claimed "abandonments and extraordinary retirements" with respect to the offshore Louisiana and MAFLA offshore leases in the amounts of $35,561,455 and $108,108,366 on its tax returns for the taxable years 1974 and 1975.[4] These amounts were claimed on the basis of claims of abandonments of mineral deposits within horizontal strata within the leases as specified above. Respondent determined that the worthlessness of the mineral interests had not been established, and disallowed, in full, the claimed deductions for abandonment of portions of the leases.

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[4] The total amount of abandonments and extraordinary losses claimed on petitioner's returns for the taxable years 1974 and 1975 were $58,773,716 and $119,994,868, respectively.

OPINION

The issues for decision are: (1) Whether certain of Gulf's interests in offshore leases were abandoned in the taxable years in issue, thereby giving rise to deductions under section 165; and (2) if such deduction is established, the amount of Gulf's basis in each lease (lease bonus plus geological and geophysical costs, where appropriate) that is properly allocable to such worthless operating minerals interests.

The determinations by the Commissioner in his statutory notice of deficiency are presumptively correct, and petitioner has the burden of disproving each individual adjustment. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Petitioner, therefore, bears the burden of proving that a loss was sustained by means of the abandonment of worthless property in the taxable years at issue.

Section 165(a) allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. In general, a deductible loss is sustained "during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year." Sec. 1.165-1(d)(1), Income Tax Regs. Losses claimed with respect to nondepreciable property must meet further requirements. Sec. 1.165-2, Income Tax Regs., provides in part:

> Sec. 1.165-2. Obsolescence of nondepreciable property.
>
> (a) *Allowance of deduction.* A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

Sustained losses deductible under this section have commonly been referred to as abandonment losses to reflect the requirement of an act that evidences an intent to discontinue use or permanently discard nondepreciable property. *A.J. Industries, Inc. v. United States*, 503 F.2d 660 (9th Cir. 1974). The act of abandonment determines the timing of the deduction for abandonment losses, and not the character of the loss. *Yarbro v. Commissioner*, 737 F.2d 479, 486-487 (5th Cir. 1984).

Petitioner and respondent have spent a considerable portion of time and effort at trial, and on brief, on the nature of the property that was claimed as an abandonment loss on petitioner's tax returns for the taxable years 1974 and 1975. Petitioner has conceded that none of the leases at issue were relinquished or terminated in the taxable years at issue. Petitioner, however, alleges that each of the potential mineral deposits established by Gulf's personnel at or shortly after the acquisition of each lease is a separate "property" which is susceptible to abandonment on an individual basis. Respondent disagrees with this definition of "property" and claims that petitioner, in any event, failed to take any action that evidenced an intent to abandon the "properties" whether the properties are the potential mineral deposits within the entire leases or each of the horizontal strata of the leases as petitioner contends.

Section 614(a) defines the term "property" in the context of "mines, wells, and other natural deposits" to be "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Sec. 1.614-1(a)(1), Income Tax Regs. The term "interest" is defined under section 1.614-1(a)(2), Income Tax Regs., as—

> an economic interest in a mineral deposit. See paragraph (b) of sec. 1.611-1. The term includes working or operating interests, royalties, overriding royalties, net profits interest, and, to the extent not treated as loans under section 636, production payments.

The general rule under section 614(a), therefore, is that if a tract or parcel contains two or more economic interests in mineral deposits, a taxpayer's interests in the deposits are correspondingly treated as two or more separate properties. If, however, the taxpayer's economic interests in the deposits contained in a tract or parcel of land constitute "operating mineral interests" the special rules of section 614(b) apply. The term "operating mineral interests" is defined in section 614(d) which provides:

> SEC. 614(d). OPERATING MINERAL INTERESTS DEFINED.—For purposes of this section, the term "operating mineral interest" includes only an interest in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for purposes of computing the 50 percent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production stage.

Accordingly, if the taxpayer's interests in the deposits contained in a tract or parcel of land contains divisible "operating mineral interests" within the definition of section 614(d), then instead of being treated as separate properties under section 614(a), all of the operating mineral interests will generally be treated as a single property under section 614(b)(1), which provides:

> SEC. 614(b). SPECIAL RULES AS TO OPERATING MINERAL INTERESTS IN OIL AND GAS WELLS.—In the case of oil and gas wells—
>
> (1) IN GENERAL.—Except as otherwise provided in this subsection—
>
> (A) all of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and
>
> (B) the taxpayer may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land.

Thus, in contrast to the general rule applied to economic interests, which treats each interest as a separate property under section 614(a), the general rule applied to the "operating mineral interests" is aggregation into one property under section 614(b)(1).

Section 614(b)(2), however, permits a taxpayer to make an election with respect to two or more operating mineral interests in a single tract or parcel of land and provides in part:

> (2) ELECTION TO TREAT OPERATING MINERAL INTETESTS AS SEPARATE PROPERTIES.—If the taxpayer has more than one operating mineral interest in a single tract or parcel of land, he may elect to treat one or more of such operating mineral interests as separate properties. * * *

The election under section 614(b)(2) in effect permits a taxpayer who has more than one operating mineral interest in a single tract or parcel of land to elect to have his operating mineral interests come within the separate property rule of section 614(a), even though such operating mineral interests would otherwise be treated as a single property pursuant to section 614(b)(1). The election must be made, at the latest, with the tax return for the first taxable year in which the taxpayer incurs any expenditure for development or operation in connection with the operating mineral interest. Sec. 614(b)(4)(A); sec. 1.614-8(a)(3), Income Tax Regs. The election made for treatment under section 614(b)(2) is effective for all purposes under subtitle A of the Internal Revenue Code. Sec. 614(b)(4)(B). More particularly, the property concepts and definitions embodied in section 614 are applicable to questions concerning deductibility under section 165. *American Smelting & Refining Co. Consolidated v. United States*, 191 Ct. Cl. 307, 423 F.2d 277, 284-285 (1970).

In this case petitioner argues that each of the deposits within the horizontal strata containing the potential for production of minerals is an operating mineral interest for which an election has been made for treatment as a separate property pursuant to section 614(b)(2). Petitioner in essence argues that, although each lease began as one property, it has divided each lease into divisible properties in the form of operating mineral interests. These separated properties would generally still be treated as one property under section 614(b)(1), but for the election that Gulf contends was made and that allows it to maintain the division of the lease under section 614(b)(2). Respondent contends that the designations within each lease set forth by petitioner do not constitute operating mineral interests. Respondent argues that the general rule of section 614(a) applies and that petitioner has not demonstrated that any one of the leases contains more than one economic interest in a mineral deposit, and that each of the leases thus constitutes only one property.[4]

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[4] During the course of a protracted and rancorous pretrial hearing, the parties stipulated that Gulf had elected to treat the horizontal strata bearing potential mineral deposits as operating mineral interests. We believe that the stipulated language does not reflect the common intention of the parties. *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965). From the transcript, it is apparent that the parties agreed only that Gulf, itself, defined these strata as operating mineral interests and did not intend to stipulate to a conclusion of law in usurpation of this Court's function. *A.B.C.D. Lands, Inc. v. Commissioner*, 41 T.C. 840 (1964);

Regardless of whether the properties at issue consist of the potential mineral deposits within horizontal strata or the entire leases, deductibility of an abandonment loss under section 165 requires first that there be a commercially reasonable determination of worthlessness. Petitioner's expert witness agreed that portions of each lease would not produce oil or gas in commercial quantities, but agreed with Gulf's determinations as to which deposits within horizontal strata were worthless only 3 times out of 12 in the MAFLA offshore area while his conclusions did not coincide with those of Gulf on any of the losses claimed for the offshore Louisiana area. He also would not have allocated the basis of the leases among the allegedly abandoned and retained portions of the leases in the same manner as did petitioner.

One of the leading cases setting forth the standards of reasonableness is *Harmon v. Commissioner*, 1 T.C. 40 (1942), affd. 139 F.2d 211 (10th Cir. 1943), revd. on other grounds sub nom. *Commissioner v. Harmon*, 323 U.S. 44 (1944). In that case, the experts for the taxpayer and respondent, all of whom were well qualified, gave conflicting testimony as to the probability of production of oil in commercial quantities. The royalty interests were disposed of by quitclaim deed in the year after the year for which the deductions were claimed. This Court stated that:

> the possibility of the recovery of oil at some time in the future from some of the lower unexplored regions of petitioner's properties may be admitted. We do not think, however, that this mere "possibility" of future production is in itself sufficient to give value to oil royalties which have been condemned as worthless by those engaged in the trade and familiar with the development in those particular areas. * * * [1 T.C. at 58.]

This Court has grappled with the issue of abandonments of horizontal strata within leases in *Brountas v. Commissioner*, 73 T.C. 491, 582-587 (1979), affd. on this issue and revd. in part 692 F.2d 152 (1st Cir. 1982), affd. on this issue

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Yagoda v. Commissioner, 39 T.C. 170 (1962), affd. 331 F.2d 485 (2d Cir. 1964), cert. denied 37 U.S. 842 (1964). Further, stipulations that are erroneous as contrary either to the facts or the law are not binding upon this Court. *Swift & Co. v. Hocking Valley Ry. Co.*, 243 U.S. 281 (1917); *King v. United States*, 641 F.2d 253 (5th Cir. 1981). In light of the history of the stipulation process in this case and in light of our finding below, we need not decide whether the horizontal strata are, by law, operating mineral interests or whether petitioner has effectively elected to treat the "operating mineral interests" as separate properties, as petitioner has failed to meet its initial burden of proving an act of abandonment.

and revd. in part sub nom. *CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982).[5] In that case which dealt with abandonments of onshore leases, we stated:

> Specifically, the timing of an abandonment loss depends on (a) the geological determination of worthlessness and (b) the payment of delay rentals.
>
> * * * * * * *
>
> * * * We believe that a geological determination of total worthlessness, coupled with the objective cessation of the payment of delay rentals, establishes that a mineral lease has been abandoned. There may be other ways in which an act of abandonment could have occurred—such as delivery to the lessor of a legally binding instrument disclaiming further rights under the lease—but we need not decide this because there is no evidence here of any irrevocable, definitive act of abandonment prior to letting the delay rental due date lapse without payment.
>
> On the other hand, regardless of whether a test well was a dry hole, if the partnerships continued to pay delay rentals for a particular lease, they were not entitled to claim an abandonment loss until there was an unequivocal act of abandonment such as letting a due date for such payments pass without payment. * * *
>
> [73 T.C. at 584-585. Fn. ref. omitted.]

In the present case, petitioner continued to pay delay rentals on each of the leases at issue during each of the relevant taxable years. The delay rentals preserved petitioner's rights to the entire lease including the purportedly abandoned potential mineral deposits within horizontal strata. Petitioner has failed to prove any act evidencing its present declaration that these properties were worthless and abandoned in the taxable years at issue, whether the term property is defined as each of the potential mineral deposits or defined as the lease itself. Petitioner retained the right to drill and explore on all portions of each of the leases as evidenced by the continuation of its own efforts and its farmout of portions of the leases. Petitioner felt that at least one deposit within each lease had sufficient value to warrant the retention not only of legal title to the lease, but of all rights appurtenant thereto. Even if the issue of the payment of delay rentals were removed from consideration, there is no objective evidence of petitioner's claim that it abandoned any portion of the leases at issue during the taxable years at issue. *A.J. Industries, Inc. v. United States, supra.*

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[5] The Third Circuit Court of Appeals is the court to which this case may be appealed and we are, therefore, bound by its decision in this issue. *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

The facts here show a clear failure on the part of petitioner to abandon the purportedly worthless property by the readily available method of the cessation of delay rentals.

> it was improper to take abandonment losses for mere pieces of a leasehold. The law is clear. To be entitled to an abandonment loss, a taxpayer must show "an intention 'to abandon the property, coupled with an act of abandonment * * *.'" *Massey Ferguson, Inc. v. Commissioner*, 59 T.C. 220, 225 (1972). Where "delay rentals" were no longer paid, the Tax Court found such an "act" and allowed the loss deduction. Where the taxpayer continued to pay "delay rentals," however, the Court found no such "act." * * *
>
> * * * The mere determination that a stratum is worthless, even if made on the advice of geological experts, does not necessarily show abandonment. As long as the investors continued to pay the delay rentals, they had the right to test other strata and even the purportedly abandoned stratum. "In a case such as this it would be more reasonable to fix the date of worthlessness as being the date when the parties refused to pay further rents * * * "
>
> [*Brountas v. Commissioner*, 692 F.2d at 162-163. Citations omitted.]

In *CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982), the companion case to *Brountas*, the Third Circuit Court of Appeals also affirmed the opinion of this Court as to this issue:

> The Tax Court held that so long as the investors continued to pay delay rentals they still had the right to explore all strata in the leasehold, and thus there was no "intention to abandon coupled with an act of abandonment." *Massey Ferguson, Inc. v. Commissioner*, 59 T.C. 220, 225 (1972). The *Brountas* court affirmed this finding.
>
> * * * Detailed treatment by us of any of these issues would serve no useful purpose. It suffices to observe the Court of Appeals for the First Circuit properly disposed of the companion appeal arising out of the same trial record.
>
> [693 F.2d at 283-284.]

Petitioner urges that its decision to take section 165 losses for the abandonment of a portion of the leases was reasonable, and that it took all possible actions to evidence that abandonment in light of the refusal of the Minerals Management Service to accept horizontal abandonments of mineral leases much less relinquishment of a mere deposit.

We agree that the "subjective judgment of the taxpayer * * * as to whether the business assets will in the future have value is entitled to great weight." *A.J. Industries, Inc. v. United States*, 503 F.2d at 670. Further, we are not requiring that petitioner sell or otherwise dispose of the properties before a claim of abandonment can be valid. *James Petroleum Corp. v. Commissioner*, 238 F.2d 678 (2d Cir. 1956), cert. denied 353 U.S. 910 (1957); *Gordon v. Commissioner*, 46 B.T.A. 1201 (1942), affd. 134 F.2d 685 (4th Cir. 1943). However, in order to claim a deduction under section 165, even a reasonable determination of worthlessness, as adjudged by a prudent and informed businessman standard, must be supported by an act of abandonment. *Harmon v. Commissioner*, 1 T.C. at 58. *Brountas v. Commissioner*, 73 T.C. at 585.

Gulf claims that relinquishment of legal title was virtually impossible as to individual deposits in the leases because of the policy of the Minerals Management Service prohibiting relinquishment of horizontal strata. Regardless of the propriety or legal standing of the attempt by Gulf to divide each lease into its component deposits, no affirmative act of abandonment occurred with respect to any potential mineral deposit or lease. Furthermore, petitioner concedes that at least one deposit in each lease warranted the continued payment of delay rentals that continued its rights to the entire lease. Petitioner's argument is self-defeating. Each lease, as a whole, retained sufficient value to petitioner in the taxable years at issue to warrant retention of purportedly worthless deposits and strata in order to retain rights to the strata bearing minerals in commercially producible quantities. Petitioner did not retain mere legal title to the allegedly abandoned potential mineral deposits by payment of the delay rentals. The payments preserved the full panoply of rights with respect to the entire lease, including the right to drill, explore, and produce from any portion of the lease whether allegedly abandoned or not. Gulf, in fact, continued the exploration and drilling process on the leases during the taxable years at issue and thereafter. The difficulty of severing a horizontal portion of a lease under Minerals Management Service regulations does not obviate the need to make an overt act of abandonment as to each property, an act which Gulf did not make, whether the property is defined as the lease or as a deposit within a horizontal strata.

In light of our finding that petitioner has failed to prove that it sustained a loss with respect to abandoned properties in the offshore Louisiana or MAFLA offshore areas that would permit a deduction under section 165, we need not determine the amount of the allowable deduction. We decide the "Worthless Properties" issue for respondent.

This opinion resolves certain severed issues only, and all other issues not previously decided in this case[7] are still before the Court.

CHARLES L. VAUGHN AND DOROTHY B. VAUGHN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 916-78. Filed July 21, 1986.

In *Vaughn v. Commissioner*, 81 T.C. 893 (1983), we held that certain installment sales by petitioners to petitioner-wife's son were bona fide and should be given tax effect in accordance with the forms of the transactions. However, we also held that petitioner-husband constructively received the proceeds of petitioner-wife's son's subsequent sale of the assets of a corporation that petitioner-husband had sold to the son. Petitioner-husband had sold the corporation under a contract that required the son to place into escrow the proceeds from any sale by him of the assets of the corporation. Petitioners filed a motion for reconsideration of our opinion. We grant petitioners' motion for reconsideration. *Held*, the son did not place in escrow the proceeds of his sale of the corporate assets; petitioner-husband did not constructively receive these proceeds. *Vaughn v. Commissioner*, *supra*, is modified.

James M. Morgan, Jr., *Rex M. Lamb III*, and *Thomas B. Wells*, for the petitioners.

Charles B. Hanfman, for the respondent.

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[7] Other issues in this docket have been decided as follows: the "Kuwait Nationalization" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 86 T.C. 937 (1986); the "Iranian Foreign Tax Credit" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 86 T.C. 115 (1986); and the "North Sea Farmout" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 84 T.C. 447 (1985).

SUPPLEMENTAL OPINION

CHABOT, *Judge*: This case is before us on petitioners' motion for reconsideration of our opinion in the above-entitled case set forth at 81 T.C. 893 (1983) (hereinafter sometimes referred to as *Vaughn I*). See Rule 161, Tax Court Rules of Practice and Procedure. In *Vaughn I*, we made findings of fact which we adopt for purposes of this supplemental opinion. However, for clarity, we begin with a brief recital of the facts pertinent to this supplemental opinion.

For some time before 1973, petitioner Charles L. Vaughn (hereinafter sometimes referred to as Charles) owned all of the stock of Perry-Vaughn, Inc. (hereinafter sometimes referred to as Perry). Perry owned several tracts of land, on which it built apartment complexes. On part of one of these tracts, Perry built the Netherlands I and II Apartments. Perry leased another part of the latter tract to petitioners. Petitioners built the Netherlands III Apartments on the leased land. Petitioners formed a two-person partnership to operate the Netherlands III Apartments. On December 22, 1972, Charles transferred his partnership interest to Steven W. Vaughn (hereinafter sometimes referred to as Steven), the son of petitioner Dorothy B. Vaughn (hereinafter sometimes referred to as Dorothy). On January 29, 1973, Dorothy transferred her partnership interest to Steven.

On or about February 2, 1973, Charles transferred all of the outstanding stock in Perry to Steven, pursuant to a contract styled "Installment Sales Contract" (hereinafter sometimes referred to as contract III). To pay for the stock, Steven gave Charles a promissory note (hereinafter sometimes referred to as note III) in the principal amount of $660,000, requiring 240 monthly payments of $4,355.70, beginning April 1, 1973. Note III provides that it is nonrecourse; i.e., Steven is not personally liable on the debt and Charles is to look only to the collateral for payment. Contract III provides that, if Steven were to liquidate Perry and resell the assets he received in the liquidation, then Steven would have to place the net proceeds of the sale in escrow.[1] Under contract III, the proceeds of the assets sale would be held in escrow under the terms set forth in a document styled "Escrow Agreement" (hereinafter sometimes referred to as the escrow agreement). Under the escrow agreement, payments under note III were to be made directly from the escrow funds.

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[1] The sales of the partnership interests also were on the installment basis. The contracts of sale of the partnership interests do not include escrow provisions.

Perry was subsequently liquidated and its assets were transferred to Steven. On May 31, 1973, Steven sold the Netherlands I, II, and III Apartments and the land on which they are located to an unrelated person. Notwithstanding the provisions of contract III, Steven did not place in escrow any of the proceeds of this sale.

Petitioners contended that the form of the three transfers to Steven reflected the substance of the transactions. On their tax returns, petitioners treated each of the transfers to Steven as a sale and reported the gain therefrom on the installment method. Respondent contended that each of the transfers to Steven should be disregarded, that Charles should be taxed on the liquidation of Perry, and that petitioners should be treated as having made the May 31, 1973, sale to the unrelated person. Respondent contended that petitioners were not eligible to use the installment method to report their gains.

We agreed in *Vaughn I* with petitioners that the form of the three transfers to Steven reflected the substance of the transactions. Accordingly, (1) Charles is not to be taxed on the liquidation of Perry, (2) petitioners are not to be treated as having made the May 31, 1973, sale to the unrelated person, and (3) with one exception, petitioners are permitted to report on the installment basis their gains from the three transfers to Steven. The one point as to which we partially agreed with respondent is our holding in *Vaughn I* that Charles is to be treated as having received in 1973 the amount of the proceeds of the May 31, 1973, sale, that were to have been placed in escrow as provided for in contract III.

The *Vaughn I* holding which petitioners seek reconsideration of is the one point on which we partially agreed with respondent.

The granting of a motion for reconsideration rests within the discretion of the Court. See, e.g., *Louisville & N. R. Co. v. Commissioner*, 641 F.2d 435, 443-444 (6th Cir. 1981), affg.

on this issue 66 T.C. 962 (1976). The Court generally denies such a motion unless unusual circumstances or substantial error is shown. *Estate of Bailly v. Commissioner*, 81 T.C. 949, 951 (1983); *Haft Trust v. Commissioner*, 62 T.C. 145 (1974), affd. on this issue 510 F.2d 43, 45 n. 1 (1st Cir. 1975). In the instant case, we grant petitioners' motion because our careful reexamination of our opinion in *Vaughn I* leads us to conclude that (1) we erred therein and (2) that error is material to the decision of the instant case.

We reaffirm those parts of *Vaughn I* which we described as follows (*Vaughn I*, 81 T.C. at 913):

> We conclude that the form of the three transfers to Steven reflect the substance of the transactions, and that these transfers constituted bona fide sales to Steven. We also conclude that Steven (and not Charles as respondent contends) received the liquidating distribution from Perry. However, we must still consider what effect the escrow agreement has on these transactions.

However, we now conclude that we erred in our *Vaughn I* analysis of "what effect the escrow agreement has on these transactions."

Although the escrow agreement is an integral part of contract III and we conclude that Charles could have enforced it, the fact remains that the agreement was never carried out. We have found that "Steven did not place the proceeds attributable to the sale of the property received as a liquidating distribution from Perry in escrow as provided for in contract III" (*Vaughn I*, 81 T.C. at 905). Steven still had the proceeds (except, of course, to the extent that he may have used some parts of the proceeds to make his installment sale payments to Charles and Dorothy), he invested these proceeds, and he earned significant amounts from these investments. *Vaughn I*, 81 T.C. at 905. We may assume that the proceeds, or the assets in which they were invested, would have been available to Steven's general creditors.

In those cases where an escrow account has led to a holding that the seller is to be treated as having constructively received the escrowed amounts, the buyer has in fact parted with the escrowed amounts. See, e.g., the cases cited in *Vaughn I*, 81 T.C. at 913. In the instant case, Steven did not part with any such amounts; Charles merely had a contractual right to require him to do so.

We conclude that Charles did not constructively receive any of the proceeds of Steven's sale.[2]

We hold for petitioners on this issue. Since the instant case is not an escrow case, it is not appropriate in this opinion to consider the position of this Court with regard to *Reed v. Commissioner*, 723 F.2d 138 (CA1 1983), revg. T.C. Memo. 1982-734.

To take account of the parties' concessions,

An appropriate order will be entered granting petitioners' motion; decision will be entered under Rule 155.

SOUTH END ITALIAN INDEPENDENT CLUB, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 35770-84. Filed July 22, 1986.

Petitioner, a social club exempt from tax under sec. 501(c)(7), conducted beano games pursuant to a Massachusetts license. Massachusetts law required the entire net proceeds of these beano games to be donated for charitable, religious, and educational uses. Petitioner's license could be revoked if it violated this or any other provision of Massachusetts law governing beano games. Petitioner donated the net proceeds of its beano games in accordance with the requirements of Massachusetts law. *Held*, petitioner's "donations" are fully deductible from its "unrelated business

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[2] It is clear that the part of our opinion in *Vaughn I*, 81 T.C. 893 (1983), that begins with the second full paragraph on page 913, and continues through the first full paragraph ending on page 917, no longer plays a part in our analysis. If we were silent with regard to this material, then some might argue that this material remains as dictum, or at least is a clue as to what we would have held if Steven had placed the funds into escrow; others might say that our analysis in the instant opinion amounts to a rejection of this material. So that unwarranted inferences are not drawn from the two opinions in the instant case, we state that this material in 81 T.C. at 913-917 is to be disregarded. See, e.g., *Zuanich v. Commissioner*, 77 T.C. 428, 457 (1981). See also the Congress' action in a somewhat similar situation, sec.1307(a)(3), Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, 1722; H. Rept. 94-1210 (to accompany H.R. 13500), 16-17 (1976), 1976-3 C.B. (Vol. 3) 46-47; S. Rept. 94-938 (Part 2), 84 (1976), 1976-3 C.B. (Vol. 3) 726; S. Rept. 94-1236 (H. Rept. 94-1515 (Conf.), 532-534 (1976), 1976-3 C.B. (Vol. 3) 936-938; Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, at 415-416 (J. Comm. Print 1976).

taxable income" as an expense under sec. 162, I.R.C. 1954, rather than as a charitable contribution under sec. 170 subject to the limitations imposed by sec. 512(b)(10).

Thomas M. Mawn, Jr., for the petitioner.
C. Ellen Pilsecker, for the respondent.

OPINION

RAUM, *Judge*: The Commissioner determined deficiencies in petitioner's income tax as follows:

Year	*Deficiency*
1979	$3,604.02
1980	2,847.10
1981	999.66

The issue presented is whether the proceeds of petitioner's beano game operation, which were required by State law to be used for charitable, religious, or educational purposes as a condition to the retention of its beano license, and which were in fact used for such purposes, were deductible in full or only as limited by section 512(b)(10), I.R.C. 1954. The case was submitted fully stipulated.

Petitioner South End Italian Independent Club, Inc. (the South End Italian Club or South End or the club) is a social club recognized by the IRS as exempt from taxation under section 501(c)(7), I.R.C. 1954. It was incorporated under the laws of Massachusetts on April 12, 1934.

During the years at issue, petitioner was licensed under the laws of Massachusetts to operate beano (otherwise commonly known as bingo) games. Petitioner's license authorized it to conduct beano games on Thursday nights at specified hours. It did so sponsor such games on a weekly basis during the years involved herein.

Under Massachusetts law, the profits earned from the sponsoring of beano games "shall be the property of the organization conducting said game, and shall be used for charitable, religious or educational purposes, and shall not be distributed to the members of such organization." Mass. Gen. Laws Ann. ch. 10, sec. 38 (West 1980). The "Lawful Purposes" for which these profits or "Net Proceeds" can by law be expended are more fully set out by certain State regulations, namely, those established by the Massachusetts

State Lottery Commission pursuant to statutory authority and identified as "Beano Regulations" in title 961 of the Code of Massachusetts Regulations (961 Code Mass. Regs.). Those regulations classify the appropriate charitable, religious, and educational uses of beano proceeds into three categories of uses: "Those which benefit needy or deserving persons, * * * foster worthy public works", and "lessen the burdens of government". 961 Code Mass. Regs. sec. 3.02(7)(a)-(c). Within these categories further description, as well as examples, of the appropriate uses of beano proceeds is provided. The "Net Proceeds" of a beano game are defined in the regulations as "Gross Receipts less taxes, prizes and reasonable and necessary expenses ordinarily incidental to the conduct of Beano games." 961 Code Mass. Regs. sec. 3.02(11). Petitioner's license to operate beano games "may be revoked at the discretion of the director [of the State lottery]" or "upon written request to the director by the city or town approving authority". Mass. Gen. Laws ch. 10, sec. 38. The "Grounds for Revocation or Suspension" of a beano license are listed at 961 Code Mass. Regs. sec. 3.03(6) as including the following:

> 1. Violation of any provision of the Beano Law, regardless of whether any criminal charges are brought or conviction results;
> 2. Violation of these Rules and Regulations or any other directives of the Director;
> 3. The request of the Local Licensing Authority;
> 4. The public interest.

On its Exempt Organization Business Income Tax Returns (Forms 990-T) for 1979, 1980, and 1981,[1] petitioner reported its income from beano as "Unrelated Business Taxable Income." The amount received from sponsoring beano games was divided and reported as two separate items of income. First, petitioner reported as "Rent Income" an amount it apportioned to rental of the club's "hall" and "quarters" used in the conduct of the beano games. Such rent income amounted to $7,950 in 1979, $11,675 in 1980, and $12,200 in 1981. Second, it reported another amount designated as "Other income", which was stipulated to represent the gross income from beano less prizes, expenses directly attributable to the games, taxes paid to the Massachusetts State Lottery Commission,[2] and the rent "paid" to petitioner noted above. That "Other income" amounted to $24,856 in 1979, $18,072.75 in 1980, and $6,740.75 in 1981.

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[1] It is stipulated by the parties that these "returns were filed during the course of the examination of petitioner's tax liability for the years at issue". They were dated Apr. 25 and 26, 1982. The Commissioner, however, does not seek additions to tax as a result of these late filings.

Contributions out of the beano proceeds, as required by Massachusetts law, were reported as made in the amounts of $22,301.02 in 1979, $18,072.75 in 1980, and $6,740.75 in 1981.[3] In 1979 and 1980, contributions were listed as made to some 42 donees; in 1981 they were listed as made to 27 donees. The recipients of the funds included the local public high school, fire department, and police association as well as local churches, medical research groups, and organizations benefiting children, senior citizens, the handicapped, the hungry, and victims of disaster.

The Commissioner, in his notice of deficiency, reduced petitioner's charitable contributions for 1979, 1980, and 1981 to $1,482.13, $1,325.56, and $860.39, respectively, "to comply with the statutory provisions of Section 512(b)(10)" which section (as in effect for those years)[4] limits the charitable deduction allowed by section 170 to "5 percent of the [petitioner's] unrelated business taxable income" computed without the benefit of charitable deductions. We hold for petitioner.

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[2] The applicable Massachusetts regulations provide that gross receipts from beano are reduced by "taxes" to determine the "Net Proceeds" which must be used for the listed purposes, but they do not specify whether the taxes referred to include Federal taxes. While it is unclear to us, petitioner seems to think that the Government challenges its deduction of only those taxes paid to the Massachusetts State Lottery Commission in computing net proceeds. We conclude that South End correctly computed its beano "Net Proceeds" under Massachusetts law. Consequently, for Federal tax purposes we treat the Massachusetts regulations as requiring charitable, religious, or educational use of before (income) tax beano proceeds. Our conclusion on this matter is supported, at least to some extent, by the structure of the Massachusetts statute involved. After requiring in sec. 38 that the profits of beano be used for specific listed purposes, the statute provides in sec. 39 for a tax to be paid to the State Lottery Commission—a tax which is clearly to be deducted from gross receipts to arrive at a profit figure—without any indication that State or Federal income taxes are to receive similar treatment.

[3] In the returns for 1980 and 1981, the amounts reported as "Other income" from beano were precisely equal to the amounts claimed as contributions. However, the 1979 contributions deduction was less than the amount of the "Other income" reported for that year. There was no explanation for the difference.

[4] This provision has since been amended to provide for a 10-percent limitation. Technical Corrections Act of 1982, Pub. L. 97-448, 96 Stat. 2374.

As a social club qualifying for tax exempt status under section 501(c)(7), I.R.C. 1954, the South End Italian Club is taxable on its "unrelated business taxable income" under section 512(a)(3), I.R.C. 1954—a special code provision applicable, for the years at issue, to "organizations described in section 501(c)(7) or (9)." While most tax exempt organizations are taxed on "unrelated business taxable income" as defined in section 512(a)(1), I.R.C. 1954, social clubs, such as petitioner, are taxed on "unrelated business taxable income" as that term is defined in section 512(a)(3), I.R.C. 1954. The tax ramifications of the application of these different definitions are significant.

The definition in section 512(a)(1) results in taxation of exempt organizations on income only if that income is generated by a trade or business that is regularly carried on and that is not substantially related to the organization's tax exempt purposes. *United States v. American Bar Endowment*, 477 U.S. ____, ____ (1986); *Iowa State University of Science and Technology v. United States*, 205 Ct. Cl. 339, 351-352, 500 F.2d 508, 516-517 (1974); *Waco Lodge No. 166 v. Commissioner*, T.C. Memo. 1981-546, 42 T.C.M. 1202, 1204, 50 P-H Memo T.C. par. 81,546. Sec. 1.513-1(a), Income Tax Regs. By contrast, section 501(c)(7) organizations are taxed on "unrelated business taxable income" as defined in section 512(a)(3) to mean all income that is not "exempt function income."[5] Sec. 512(a)(3)(A), I.R.C. 1954. "Exempt function income" is then defined in section 512(a)(3)(B) as follows:

> (B) EXEMPT FUNCTION INCOME.—For purposes of subparagraph (a), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside—
>
> (i) for a purpose specified in section 170(c)(4) * * *

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[5] Because a social club's "unrelated business taxable income" is not defined in terms of income generated from an "unrelated trade or business", sec. 513(f), which excludes "any trade or business which consists of conducting bingo games" from classification as an "unrelated trade or business", has no application here.

A social club is thus taxed on all income other than that received from members in exchange for goods and services and other than a limited amount that is set aside for "religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals"—the purposes specified in section 170(c)(4).[6] Thus, to be taxable, the income of a social club need not be generated by a "trade or business". The use of the term "unrelated business taxable income" to describe a social club's income that is subject to tax is something of a misnomer which is used nonetheless, presumably because it functions conveniently (although confusingly) to plug social clubs into the preexisting scheme for taxation of exempt organizations.

This distinct tax treatment of social clubs stems from revisions to section 512(a) made by section 121 of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 537. Such revisions were made in order to extend the unrelated business income tax which applied to some tax exempt organizations (such as educational, charitable, and religious organizations) to those organizations, such as social clubs, which were previously entirely exempt from tax, since the previously untaxed organizations were "equally apt to engage in unrelated business." H. Rept. 91-413, at 47 (1969), 1969-3 C.B. 230. By introducing the "exempt function income" concept the statute was intended to go even further, taxing the "investment income of organizations which are exempt on the grounds of mutuality or common membership." H. Rept. 91-413, at 47. Congress' rationale for so extending the taxation of social clubs was rooted in the fact that their tax exemption was originally "designed to allow individuals to join together to provide recreational or social facilities on a mutual basis, without tax consequences." H. Rept. 91-413, at 48. S. Rept. 91-552, at 71 (1969), 1969-3 C.B. 469-470. Accordingly, it was reasoned, "the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership * * * [W]here the organization receives income from sources outside the membership * * * upon which no tax is paid, the membership receives a benefit not contemplated by the exemption." H. Rept. 91-413, at 48; S. Rept. 91-552, at 71.

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[6] Petitioner makes no argument that a portion of the beano receipts is exempt as charges for services provided to members. Further, no argument is made that the beano proceeds and related donations qualify as "exempt function income" under the provision of sec. 512(a)(3)(B)(i) allowing for a "set aside" of income to be used for charitable purposes. Instead, both parties agree that the club's income from beano is taxable. The basis for their agreement on this issue is their position that the club's beano operation is a "trade or business"—a rather curious basis for a conclusion on taxability of income given the absence of a "trade or business" requirement in the provisions for taxation of social clubs. Petitioner seems to take this position in order to support its contention that the donations are deductible, not under sec. 170, but under sec. 162 as ordinary and necessary expenses incurred in the conduct of a "trade or business". In taking this position, petitioner overlooks our holding in *The Brook, Inc. v. Commissioner*, T.C. Memo. 1985-614, 51 T.C.M. 133, 54 P-H Memo T.C. par. 85,614, that connection with such a trade or business is *not* a condition of deductibility of expenses under sec. 162 when taxation of a social club is at issue.

When social clubs were thus brought into the existing scheme for taxation of exempt organizations, they were made subject to some of that scheme's provisions for deduction of related expenses. A social club's "unrelated business taxable income" is reduced by "the deductions allowed by this chapter which are directly connected with the production of the gross income * * * both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b)." Sec. 512(a)(3)(A), I.R.C. 1954. Those deductions provided for in chapter 1 are to be allowed against "an activity [of a social club] generating income subject to tax" without regard to whether that activity is "an unrelated trade or business regularly carried on". (Emphasis in original deleted.) 3 U.S. Treasury Dept., Tax Reform Studies and Proposals 325 (Comm. Print of House Ways and Means Comm. and Senate Finance Comm. 1969). See *Cleveland Athletic Club, Inc. v. United States*, 779 F.2d 1160 (6th Cir. 1985); *Ye Mystic Krewe of Gasparilla v. Commissioner*, 80 T.C. 755 (1983); *The Brook, Inc. v. Commissioner*, T.C. Memo. 1985-462, 50 T.C.M. 959, 962 n. 4, 54 P-H Memo. T.C. par. 85,462, at 85-2065, Supplemental Opinion T.C. Memo. 1985-614, 51 T.C.M. 133, 135, 54 P-H Memo T.C. par. 85,614, at 85-2744. This Court has held that a social club can take deductions allowed by section 162 against any taxable income, whether or not generated by a trade or business and, in so holding, has specifically rejected as "both unreasonable and unwarranted" the Government's contrary construction of section 512(a)(3)(A). *The*

Brook, Inc. v. Commissioner, 51 T.C.M. at 135, 54 P-H Memo T.C. at 85-2743.[7]

At issue in this case is the deductibility, from beano income, of those proceeds of such income which were donated pursuant to the requirements of Massachusetts law. The specific question is whether the payments made are properly deductible under the general rule in section 512(a)(3)(A) concerning "the deductions allowed by [chapter 1]" or under a modified rule contained in section 512(b)(10) concerning "deduction[s] allowed by section 170". If the payments qualify under the former provision, they are fully deductible; if they come within the latter, their deductibility is limited to "5 percent of the [petitioner's] unrelated business taxable income." Sec. 512(b)(10), I.R.C. 1954.

Petitioner argues on brief that the donations required by Massachusetts law to be made out of beano receipts are "expenses deductible as ordinary and necessary business expenses under Section 162". In order to be deductible as a business expense under section 162—and thereby *fully* deductible under section 512(a)(3)(A)—the donations must first fail to qualify as "contributions or gifts to organizations described in section 170". Sec. 1.162-15(a)(2), Income Tax Regs. See *Marquis v. Commissioner*, 49 T.C 695, 699-700 (1968); *Stover Co. v. Commissioner*, 27 T.C. 434, 442 (1956); *Lysek v. Commissioner*, T.C. Memo. 1975-293, 34 T.C.M. 1267, 1275, 44 P-H Memo T.C. par. 75,293, at 75-1247; *Jefferson Mills, Inc. v. United States*, 259 F. Supp. 305, 311-312 (N.D. Ga. 1965), affd. per curiam 367 F.2d 392 (5th Cir. 1966); Rev. Rul. 63-73, 1963-1 C.B. 35. They must also prove to be eligible for deduction under section 162, I.R.C. 1954. We are convinced that petitioner's payments satisfy both of the above requirements and are thereby entitled to treatment as business expenses which are fully deductible under section 512(a)(3)(A).

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[7] In *The Brook, Inc. v. Commissioner*, 51 T.C.M. at 135, 54 P-H Memo T.C. par. 85,614, at 85-2744, it was stated:

"we think that a reasonable reading of section 512(a)(3)(A) is that Congress, having decreed that a social club's income from all sources (other than member sources) was to be treated as *business* income, then intended that the deductions allowed by chapter 1 with respect to *business* income should be allowable as deductions against the income produced by each unrelated activity, whether in fact such activity constituted the carrying on of a business or not." [Emphasis in original.]

First, petitioner's payments were made in compliance with a Massachusetts law requiring the donation of the "Net Proceeds" of petitioner's beano games. Given the legal compulsion surrounding petitioner's making of the donations, they can hardly qualify as voluntary charitable contributions. See *Allen v. United States*, 541 F.2d 786 (9th Cir. 1976); *Perlmutter v. Commmissioner*, 45 T.C. 311 (1965); *Lombardo v. Commissioner*, T.C. Memo. 1985-552, 50 T.C.M. 1374, 54 P-H Memo T.C. par. 85,552. Cf. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960); *United States v. Transamerica Corp.*, 392 F.2d 522, 524 (9th Cir. 1968).

Further, the club's beano license could be revoked if petitioner were to violate the donation requirement of the Massachusetts Beano Law. Accordingly, obtaining the assurance that its license would not be revoked for failure to comply with that requirement was itself a quid pro quo for the donations. The consequence of holding the license was that petitioner could provide its members with the opportunity to play beano. Moreover, it was the beano license that allowed the club to earn gross rentals ranging from $7,950 to $12,200 in the years at issue. It has long been established that the receipt of such benefits will disqualify a donation from classification as a charitable contribution. See *Oppewal v. Commissioner*, 468 F.2d 1000, 1002 (1st Cir. 1972); *Crosby Valve & Gage Co. v. Commissioner*, 380 F.2d 146, 147 (1st Cir. 1967), affg. 46 T.C. 641 (1966); *Murphy v. Commissioner*, 54 T.C. 249, 253 (1970); *Channing v. United States*, 4 F. Supp. 33, 34 (D. Mass. 1933). Petitioner's payments are so disqualified here.[8]

In addition to failing to meet the requirements for deductibility as charitable contributions, the donations must qualify under a code provision in chapter 1 to be fully deductible under section 512(a)(3). Here, deductibility is sought under section 162, I.R.C. 1954. We agree with petitioner's contention that the payments were ordinary and necessary expenses under section 162 which were "directly connected with the production of the gross income" from beano operations under section 512(a)(3).

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[8] Also, the range of eligible recipients under the Massachusetts regulations include some classes of donees that probably would not have qualified some donations as deductible under sec. 170 (e.g., to fraternal organizations), but that could properly have been classified as "ordinary and necessary" expenses in view of the requirements of Massachusetts law.

The donations were both ordinary and necessary expenses. They were clearly necessary, in the strict sense of the word, to the lawful conduct of beano games by petitioner since they were required by Massachusetts law as a condition to the retention of its license to operate such games. See *Welch v. Helvering*, 290 U.S. 111 (1933). Further, the donations were currently deductible ordinary expenses in the nature of an annually recurring licensing expense. See *Nachman v. Commissioner*, 12 T.C. 1204, 1208, 1212 (1949), affd. 191 F.2d 934 (5th Cir. 1951); *Haman v. Commissioner*, T.C. Memo. 1972-118, 31 T.C.M 466, 41 P-H Memo T.C. par. 72,118. Rev. Rul. 77-124, 1977-1 C.B. 39. Compare *P. Liedtka Trucking Co. v. Commissioner*, 63 T.C. 547, 555 (1975); *Toledo T.V. Cable Co. v. Commissioner*, 55 T.C. 1107, (1971), affd. per curiam 483 F.2d 1398 (9th Cir. 1973); *Ryman v. Commissioner*, 51 T.C. 799, 801-803 (1969); *Tube Bar, Inc. v. Commissioner*, 15 T.C. 922, 929-930 (1950). Since the yearly cost (in contributions) to petitioner of maintaining its license is an ordinary and necessary expense, the donations required to be made by Massachusetts law are properly fully deductible from South End's beano income.

This result is fully consistent with Congress' purposes in imposing a tax on the income of social clubs. To the extent that the South End Italian Club's beano income would be available to reduce "the members' costs below the actual cost of providing the personal facilities made available by the organization" such income is taxed. H. Rept. 91-413, at 47 (1969), 1969-3 C.B. 231. The portion of South End's beano income that is required to be donated is not available to benefit the membership, is properly characterized as an expense under section 162 (rather than as a charitable contribution under section 170), and is fully deductible from petitioner's unrelated business taxable income under section 512(a)(3)(A).

Decision will be entered for the petitioner.

RONALD COLEMAN AND NANCY COLEMAN, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 7216-83. Filed July 23, 1986.

Petitioners purchased an interest in certain computer equipment from C, which had purchased such interest from E, which had purchased an interest in the equipment from A. Petitioners then leased their interest back to C. *Held*, petitioners did not have a depreciable interest in the equipment during the years in issue. *Held, further*, interest payments on petitioners' nonrecourse note, which does not constitute genuine indebtedness, are not deductible. *Held, further*, interest payments on a recourse note are deductible.

Matthew H. Ross and *Leon C. Baker*, for the petitioners.[1]
Susan G. Lewis and *Patricia H. Delzotti*, for the respondent.

TANNENWALD, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes for taxable years 1979 and 1980 of $2,189 and $2,442, respectively, relating to petitioner Nancy Coleman's 1-percent interest in a computer leasing transaction. In his amended answer, respondent alleged additional deficiencies for taxable years 1979 and 1980 of $31,840 and $64,700, respectively, relating to petitioner Ronald Coleman's interest in the same transaction. The issues for decision are whether petitioners' deductions for depreciation and interest expenses were properly disallowed.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. This reference incorporates the stipulations of facts and attached exhibits. At the time they filed their petition in this case, petitioners resided in Oradell, New Jersey. Petitioners timely filed joint Federal income tax returns for 1979 and 1980.

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[1] Brief amicus curiae was filed by *Martin Allen* as attorney for the Computer Dealers & Lessors Association. To some extent, the brief of the amicus curiae and, to a greater extent, respondent's response thereto went beyond the record herein. Such extracurricular excursions were totally without effect on the Court's analysis and decision herein.

During the years 1979 and 1980, petitioner Ronald
leman was a one-third partner in Majestic Construction
. (Majestic), a New Jersey general partnership. The other
rtners were Ronald Coleman's brothers, Harvey and
illiam Coleman. Majestic's business was constructing
ntal income properties for its own account. During 1979,
illiam Coleman and Leon C. Baker, a first cousin of the
olemans and an attorney who had been involved with
quipment leasing since 1972, discussed Majestic's need for
tax shelter and the economic and tax aspects of computer
asing. Baker approached Nigel Leopard, a representative
f Carena [Computers] B.V. (Carena), a Netherlands corpora-
ion, to develop a deal for the Colemans. Baker had dealt
ith Leopard for about 7 years, the latter generally acting
s an intermediary between European leasing companies
nd American brokers who, in turn, sought investors for
quipment leasing transactions. Baker sought from Leopard
n equipment transaction that gave the Colemans an
"inside price," i.e., a higher percentage of leverage than
that featured in typical equipment deals.

Leopard contacted Vernon Davies, cofounder and, at that time, president of Atlantic Computer Leasing p.l.c. (Atlantic). Atlantic, a United Kingdom (U.K.) corporation, was a large, reputable supplier of configured computer systems consisting of IBM central processors, IBM operating systems, and IBM and IBM-compatible peripherals. Atlantic supplied such equipment mainly through "arranged leases," i.e., transactions in which Atlantic arranged financing for its customers by transferring title to the equipment to financial institutions or corporate leasing subsidiaries and arranging leases between these parties as lessors and the customer-users as lessees. To a lesser extent, Atlantic utilized direct leases and outright sales to its customers. Leopard had known Davies for approximately 2 years, and had done several deals with him, by the time of their meeting regarding the Colemans' transaction. Their negotiations centered on certain computer equipment (the equipment) financed through leases "arranged" between seven lessors (the lenders) and six end users and having the terms set forth in the chart on pages 180-181.[2]

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[2] For the notes to the following table, see p. 181 *infra*.

User-lessee	*Lender-lessor*	*Quantity*	*Equipment*	*Initial lease term*[1]	*Monthly rental (exclusive of VAT)*[2]
(1) Reuters, Ltd.	Mansfield Hosery Mills, Ltd.	1 1	3138-J Processor 3046-l Power unit	Dec. 28, 1979– June 28, 1982	£5,298
(2) Northumberland County Council	Beaverline Leasing, Ltd.	1 1	3138-J Processor 3046-l Power unit	Nov. 5, 1979– Nov. 5, 1982	£5,550 for first 2 years, £4,000 thereafter
(3) Thomson Travel, Ltd.	Thompson, Lloyd & Ewart, Ltd.	1	3330-1 Disk storage	Feb. 27, 1978 Feb. 27, 1982	£587
(4) Torrington Co., Ltd.	Anochrome, Ltd.	1 1 1 1	3135-I Processor 3046-1 Power unit 3215-1 Console printer 1403-N1 Printer	Mar. 1, 1979– Mar. 1, 1984[3]	£2,500
(5) Chesire County Council	A. Beckman, Ltd.	2 1 1	3350-B2 Direct access storage 3350-A2 Direct access storage 3350-C2 Direct access storage	June 29, 1979– Dec. 29, 1985	£1,490
(6) Cheshire County Council	Noble Grossart, Ltd.	1 1	333-11 Disk storage and control 3330-11 Disk storage	July 13, 1979– Jan. 13, 1986	£960

(continued)

(7) Cheshire County Council	Noble Grossart, Ltd.	2	3830-2 Storage control	Sept. 28, 1979– Mar. 28, 1986	£3,200
		1	3350-A2 Direct access storage		
		1	3350-B2 Direct access storage		
(8) C & J Clark, Ltd.	S. Mason Leasing, Ltd.	1	1403-N1 Printer	Mar. 30, 1979	£895
		1	2821-2 Control unit	Mar. 30, 1981	

[1] We note that the initial terms for leases 1 and 2 began after the negotiations between Leopard and Davies probably took place, and that the Reuters lease began after the execution of the agreements comprising the instant transaction. However, given no indication to the contrary, we will assume that the leases were all negotiated and "arranged" prior to the negotiations and agreements relating to the instant transaction.

[2] VAT is the U.K. value-added tax, imposed on consumption at every level. Atlantic's leases provided for a monthly or quarterly rental "Plus V.A.T."

[3] The Torrington lease provides for commencement of the 5-year term "On Acceptance." The record, however, does not contain a copy of the acceptance note. Based upon the other leases and acceptances, and upon the February 23 execution of the Torrington lease, we estimated an early March commencement of the Torrington lease term. Such estimate, incorrect at most by a month, has no bearing on our decision herein.

In each of these "arranged-lease" transactions, Atlantic had purchased the equipment, transferred title thereto to the lender, and arranged the initial lease between the lender and the user-lessee.[3] Atlantic generally transfers title to lenders in order to get lower financing rates from them, and thus to be competitive in the user market; because U.K. tax law provides for first-year expensing of equipment costs by the title holder, and lenders offer better rates in exchange for title to the equipment. In each case, the lender provided Atlantic with an amount based upon the discounted value of the stream of rents receivable under the leases being arranged. Such amount included the value-added tax (VAT) imposed by the United Kingdom on consumption.[4] In each lease agreement, the lender covenants to the user-lessee that it is "the lawful owner of the Machines leased hereunder." Additionally, each of the leases contains an automatic renewal provision that is to take effect if the lessee does not terminate its lease in writing within 3 months after completion of the initial term. Atlantic bears no recourse credit risk with respect to the arranged leases; upon default by a lessee, the lender, as lessor, is entitled under its lease agreement to take immediate possession of the subject equipment, and would look to Atlantic for help in arranging a new lease in order to recoup its losses. Atlantic has no legal obligation to provide such help.

Concurrently, Atlantic and the lenders entered into residual agreements whereby Atlantic retained or still retains options to repurchase the equipment for nominal consideration upon completion of the leases' initial terms, "subject to the receipt of all monies due thereunder or the receipt of an agreed early termination settlement."[5] Atlantic generally looks to the residual value of equipment to make a profit on its "arranged-lease" transactions. This is so because the combination of intense competition in the user market, forcing low rentals and thus lower payments from lenders, the necessity of giving the lenders title to the equipment during the initial lease terms, and the costs associated with arranging the lease transactions and purchasing the equipment frequently drains the initial leases of any profit potential for Atlantic. Atlantic carried its residual interests in the equipment on its balance sheet at a discount from the IBM list price in effect at the time of valuation, less the cost of repurchase under the residual agreements and estimated remarketing costs. A valuation committee meets regularly to calculate the appropriate discount factors for the various equipment in which Atlantic has residual interests, and takes into account factors such as the equipment type, the initial lease terms, money market rates, and IBM product announcements; with regard to the last factor, the committee, based on past experience with the

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[3] A 1983 prospectus offering shares of Atlantic refers to these arranged leases as follows:

"Equipment is purchased by Atlantic from suppliers and sold to third party lessors, usually banks or other financial institutions, with the benefit of a lease entered into by Atlantic's customer. The terms of the sale depend upon prevailing rates of interest and other factors, including the time of year at which a lease is entered into, levels of economic activity and relevant tax legislation. Atlantic does not bear the credit risk in respect of arranged leases.

"Atlantic retains a residual interest in the form of an option to acquire the equipment for an amount up to 2 percent of the original selling price at the expiry of the primary lease term or upon earlier termination of the lease. * * *"

[4] Apparently, the lenders paid Atlantic the discounted value of the rental stream including VAT because they received a VAT credit from the U.K. tax authority for VAT amounts remitted to Atlantic. VAT amounts received by the lenders with the lessees' rental payments were apparently turned over to the United Kingdom.

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[5] Atlantic retained a 90-day option to repurchase with respect to the leases numbered 4 and 5, see p. 180 *supra*: with respect to the other leases, Atlantic retained a right to repurchase not specifically limited in time. The repurchase price under the residual agreements is £1 for leases 3 and 8, 1/2 percent of the Lender-lessor's original "cost" (i.e., amount of funds provided) for lease 5, 1 percent of such cost for leases 2 and 4, and 2 percent of such cost for leases 1, 6, and 7. Atlantic's total repurchase price, assuming repurchase at the end of each of the initial lease terms, may be computed as follows:

Lease	*Repurchase price*	
(1) Reuters	£3,218	(.02 x £160,903)
(2) Northumberland	1,894	(.01 x £189,379)
(3) Thomson travel	1	
(4) Torrington	1,439	(.01 x £143,851)
(5) Cheshire	502	(.005 x £100,418)
(6-7) Cheshire	5,486	(.02 x £274,277)
(8) C & J Clark	1	
Total	£12,541	

See p. 186 *infra*. For the 3 Cheshire leases, for which the record contains one aggregate "financing obtained" figure, we computed the repurchase prices by allocating the total financing obtained from the lenders on such leases to the individual Cheshire leases pro rata by the rentals stated on the leases.

All of the agreements give Atlantic, on repurchase, the benefit of any lease not terminated at the end of its initial term. Early termination (e.g., due to default by a lessee) has the following consequence: for leases 3 to 8, Atlantic has the same repurchase rights as in the case of no early termination; for leases 1 and 2, Atlantic has a right to repurchase the equipment for a price equal to the discounted value of the equipment, less any termination charge received by the lender-lessor, plus the repurchase price that would apply without early termination. For leases 1, 2, 6, and 7, in the event the lender-lessor accepts a follow-on lease with the same lessee within 6 months after the end of the initial lease term, the lender-lessor is required to refund to Atlantic 50 percent of Atlantic's repurchase price, i.e., the £1, 1/2 percent, 1 percent, or 2 percent.

accuracy of such announcements, exercises a degree of skepticism, and does not accept such announcements at face value. Remarketing costs include the expenses necessary to refurbish the equipment to the engineering and cosmetic specifications of the new user-lessees after the completion of the initial leases. These expenses total up to 15 percent of the cost of the equipment being refurbished. Maintenance and repair expenses necessary to bring the equipment as configured to peak performance are not included in the remarketing costs, as user-lessees are required to arrange with IBM for such maintenance. The user-lessees are also required to carry insurance on the equipment.

The financial information with respect to the equipment is as shown in the chart on pages 186-187.[6]

Leopard negotiated with Davies a deal known to Atlantic as a "forward sale," whereby Atlantic sells to an investor its residual interest in leased equipment.[7] Their intense negotiations centered on the amount of cash that would flow from the Colemans to Atlantic, and the degree to which the Colemans would share in the residual value of the equipment. Upon the conclusion of these negotiations, Baker. apparently after ironing out the details with Leopard, wrote the following letter, dated October 16, 1979, to William Coleman proposing the equipment leasing deal:

> Dear Bill:
>
> Enclosed are two schedules on an equipment leasing deal which I believe would be suitable for your purposes. The first schedule provides for no minimum net cash flow and the second provides for a small minimum. Naturally, the cash investment is higher in the second case. In either case, there would be contingent rent payable commencing in the fifth year.
>
> The equipment would be data processing or other office equipment with a six year depreciation life for tax purposes. The cash investment would be approximately 7½% of cost without minimum cash flow and approximately 8.55% of cost with minimum cash flow. The investment can be

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[6] For the notes to the table on page 186, see page 187.

[7] A 1983 prospectus offering shares of Atlantic refers to the forward sales as follows:

"Such sales, which relate to equipment at present on lease, involve the receipt by Atlantic of almost all of the sales price within eighteen months of the sale although delivery will take place some 7 to 11 years in the future. * * * These transactions depend for their economic viability from the purchaser's point of view, upon the provisions of the tax legislation of the United States of America. Accordingly any change in the relevant tax legislation or administrative practice on the part of the United States Internal Revenue Service could reduce sales of the kind hitherto made by Atlantic, or possibly cause them to cease."

paid in three installments over a period spaced over three fiscal years, with interest on the unpaid portion of the investment of 12% per annum.

As in all tax shelters, the key is leverage. You invest 7.5 or 8.55 cents and you depreciate $1.00.

The good news is that you could generate tax losses, per $1,000,000 of equipment, of $90,000 in 1979 and $146,696 in 1980, which could be carried back to 1979. Actually, since there are four of you, you could get $16,000 of first year depreciation in 1979, if you have not taken this amount on other property, and $40,000 of accelerated depreciation in each year without paying minimum tax. This would bring the total for the two years to over $400,000 so you could solve your entire 1979 problem with two $1,020.000 [sic] units.

By 1981 your new project should be generating substantial ordinary income so you could use the additional deductions generated in 1981 through 1984.

The bad news, of course, is that in 1985 the deal turns around and you would start generating taxable income without cash flow. There are ways to avoid this, but the conservative assumption to make is that you will be obligated to pay the taxes projected in the years 1985 through 1990.

How do you make out overall? The last column entitled "Sinking Fund Analysis at 7% A.T." assumes that net tax savings are invested to earn 7% after taxes and that the accumulation is used to pay the taxes when they become due. (Actually, of course, no one does this. It is only a method of financial analysis.) You will note that the accumulation as a $1,020,000 "module" grows to a maximum of $466,011 and then declines to $199,461. At no time do you have any net investment in the deal and you wind up with $199,461 even after paying taxes. You would be paying the taxes, of course, in dollars which are likely to be worth much less than the tax dollars you would be saving currently.

As I indicated earlier, there are three favorable possibilities which are not reflected in the tables: (l) you may be able to avoid the tax on the turnaround if there is no change in law before 1985; (2) you may receive contingent rental; and (3) the equipment may have residual value in 1990. There are pluses but the deal should be evaluated on the basis that none will eventuate.

If you are interested, I will have to contact the owners of the equipment to make sure that there is $2,000,000 available (or whatever amount you are interested in). I am leaving for China on October 26, so, if you want to proceed you should let me know before then, even though the closing need not take place until later.

Sincerely yours,

(S)Leon C. Baker

The schedules referred to in Baker's letter read, in relevant part, as shown on pages 188-189.

The table on page 190 represents the comparable calculations, under the "contingent flow assumption," on an

Lease	*Date of Atlantic's purchase*	*Cost to Atlantic (including VAT)*	*IBM (UK) list price (including VAT) late 1979*[1]	*Amount obtained from lenders*
(1) Reuters	**July 27, 1977**	**[2]£308,103.48**	**£267,547.50**	**£160,903**
(2) Northumberland	**Nov. 5, 1979**	**[3]£136,016.25**	**£229,897.65**	**£189,379**
(3) Thomson Travel	**Jan. 10, 1979**	**[4]£18,079.21**	**£27,694.30**	**£29,489**
(4) Torrington	**Jan. 30, and Feb. 15, 1978**	**[5]£220,018.00**	**£475,459.45**	**£143,851**
(5-7) Cheshire	**June 29, July 12, and Sept. 28, 1979**	**[6]£238,545.98**	**£351,466.45**	**£374,695**
(8) C & J Clark	**Nov. 6, 1978**	**£29,700.00**	**£54,605.45**	**£23,461**
Totals		**£950,462.92**	**£1,406,670.70**	**£921,778**
Conversion to dollars[7]		**$1,831,500.72**	**$2,710,593.47**	**$1,776,226.13**

[1] We calculated the figures in this column by pricing the equipment appearing on the invoices using the 1979 IBM (U.K.) price list, all of which are part of the record herein. For the Northumberland lease (number 2), no invoice appears; thus, we used the equipment list appearing on the lease, as apparently petitioners' expert did in compiling his financial information. Our figures differ in some instances from those presented by petitioners' experts.

[2] This figure inexplicably differs from petitioners' expert's figure. Our figure comes directly from the invoice purported by petitioners to relate to the equipment on the Reuters lease (number 1). We note that the purported invoice, however, lists equipment not identical to that listed on the Reuters lease—the invoice lists a 3138-I processor while the lease lists a more expensive 3138-J processor. We calculated the cost to Atlantic based on the invoice, as such is the only evidence thereof, and the IBM (U.K.) list price based on the actual equipment leased.

[3] As noted, note 1 *supra*, no invoice for this equipment appears in the record herein. The only evidence of Atlantic's purchase is a copy of a ledger page containing this figure and date.

[4] Atlantic acquired this equipment from a French company for 145,000 French francs, and apparently paid no VAT (known in France as TVA) thereon. For comparative purposes, we have added 15 percent to a figure in pounds appearing in handwriting on the invoice, used by petitioners' expert and nowhere objected to by respondent. We note that this would place the exchange rate at about 9.22 FF/£.

[5] For this figure, we defer to petitioners' expert, as the invoices in the record herein refer to slightly different equipment from that covered by the Torrington lease.

[6] We note that two of the three invoices relating to the Cheshire leases are made out to Cheshire County Council, rather than Atlantic. Also, as with the Reuters equipment, one of the Cheshire leases lists equipment (model numbers 3330-11 and 3333-11) different from that listed on the related invoice (model numbers 3330-01 and 3333-01). We resolved this problem in the same manner as we did the Reuters problem. See note 2 *supra*.

[7] For purposes of comparison with the stated purchase prices in the later agreements, we converted the amounts in pounds sterling to dollars and subtracted out the VAT components, using the exchange rate asserted by petitioners and undisputed by respondent for Dec. 26, 1979, $2.216/£, and the 15-percent VAT rate.

DATA PROCESSING EQUIPMENT LEASE
MINIMUM CASH-FLOW

Year	*Rental income*	*Depreciation S.L. 6 years*	*Legal expense and interest on deferred investment*	*Mortgage*		*Cash-flow*	*Tax loss (income)*	*Tax savings (tax) 70%*	*Tax savings plus cash-flow*	*Investment*	*Accumulation*	*Sinking fund (7% after tax)*
				Amortization	*Interest*							
1979	0	$85,875	$5,000	0	0	0	$90,875	$63,613	$63,613	$33,000	$30,613	$30,613
1980	$83,575	171,750	3,150	$25,825	$57,000	$750	148,325	103,828	104,578	38,650	65,928	98,684
1981	167,150	171,750	2,040	56,392	109,258	1,500	115,898	81,129	82,629	19,040	63,589	169,190
1982	167,150	171,750		63,362	102,288	1,500	106,888	74,822	76,322		76,322	257,355
1983	167,150	171,750		71,194	94,457	1,500	99,056	69,339	70,839		70,839	346,209
1984	167,150	171,750		79,993	85,657	1,500	90,257	63,180	64,679		64,679	435,123
1985	167,150	85,875		89,881	75,770	1,500	(5,505)	(3,854)	(2,354)		(2,354)	463,227
1986	167,150			100,990	64,661	1,500	(102,490)	(71,743)	(70,243)		(70,243)	425,410
1987	167,150			113,472	52,179	1,500	(114,972)	(80,480)	(78,980)		(78,980)	376,209
1988	167,150			127,497	38,153	1,500	(128,997)	(90,298)	(88,798)		(88,798)	313,746
1989	167,150			143,256	22,395	1,500	(144,756)	(101,329)	(99,829)		(99,829)	235,879
1990	83,575			78,137	4,688	750	(78,887)	(55,221)	(54,471)		(54,471)	197,919

DATA PROCESSING EQUIPMENT LEASE
CONTINGENT CASH-FLOW ONLY

Year	*Rental income*	*Depreciation S.L. 6 years*	*Legal expense and interest on deferred investment*	*Mortgage*		*Cash-flow*	*Tax loss (income)*	*Tax savings (tax) 70%*	*Tax savings plus cash-flow*	*Investment*	*Accumulation*	*Sinking fund (7% after tax)*
				Amortization	*Interest*							
1979	0	$85,000	$5,000	0	0	0	$90,000	$63,000	$63,000	$33,000	$30,000	$30,000
1980	$82,825	170,000	2,520	$25,825	$57,000	0	146,695	102,687	102,687	32,520	70,167	102,267
1981	165,650	170,000	1,440	56,392	109,258	0	115,048	80,534	80,534	13,440	67,094	176,520
1982	165,650	170,000		63,362	102,288	0	106,638	74,647	74,647		74,647	263,523
1983	165,650	170,000		71,194	94,457	0	98,806	69,164	69,164		69,164	351,134
1984	165,650	170,000		79,993	85,657	0	90,007	63,005	63,005		63,005	438,718
1985	165,650	85,000		89,881	75,770	0	(4,881)	(3,417)	(3,417)		(3,417)	466,011
1986	165,650			100,990	64,661	0	(100,990)	(70,693)	(70,693)		(70,693)	427,939
1987	165,650			113,472	52,179	0	(113,472)	(79,430)	(79,430)		(79,430)	378,465
1988	165,650			127,497	38,153	0	(127,497)	(89,248)	(89,248)		(89,248)	315,709
1989	165,650			143,256	22,395	0	(143,256)	(100,279)	(100,279)		(100,279)	237,530
1990	82,825			78,137	4,688	0	(78,137)	(54,696)	(54,696)		(54,696)	199,461

Year	Rental income	Depreciation S.L. 6 years	Legal expense and interest on deferred investment	Mortgage		Cash-flow	Tax loss (income)	Tax saving (tax) 70%	Tax saving plus cash-flow	Investment	Accumulation	Sinking fund (7% after tax)
				Amortization	Interest							
1979	0	$171,296	$5,000	0	0	0	$176,296	$123,407	$123,407	$66,176	$57,231	$57,231
1980	$158,206	342,592	5,053	$43,903	$114,303	0	303,742	212,619	212,619	65,213	147,406	208,643
1981	316,412	342,592	1,444	95,866	220,546	0	248,170	173,719	173,719	25,508	148,211	371,459
1982	316,412	342,592		107,715	208,697	0	234,877	164,414	164,414	0	164,414	561,875
1983	316,412	342,592		121,029	195,383	0	221,563	155,094	155,094	0	155,094	756,301
1984	316,412	342,592		135,988	180,424	0	206,604	144,623	144,623	0	144,623	953,865
1985	316,412	171,296		152,796	163,616	0	18,500	12,950	12,950	0	12,950	1,033,585
1986	316,412			171,682	144,730	0	(171,682)	(120,177)	(120,177)	0	(120,177)	985,759
1987	316,412			192,902	123,510	0	(192,902)	(135,031)	(135,031)	0	(135,031)	919,731
1988	316,412			216,745	99,667	0	(216,745)	(151,721)	(151,721)	0	(151,721)	832,391
1989	316,412			243,534	72,878	0	(243,534)	(170,474)	(170,474)	0	(170,474)	720,185
1990	316,412			273,634	42,778	0	(273,634)	(191,544)	(191,544)	100	(191,644)	578,954
1991	158,206			149,250	8,956	0	(149,250)	(104,475)	(104,475)	0	(104,475)	515,006
Total	3,480,532	2,055,552	11,497	[1]1,905,044	1,575,488	0	162,005	113,404	113,404	156,997	(43,593)	515,006

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[1] The difference between this amount and the $1,905,053 face value of the nonrecourse note is due to rounding off.

annual basis and based upon a 70-percent marginal tax rate and the cost, rental, and purchase price payments actually involved herein.

Baker, based upon his admittedly second-hand experience with computer leasing, believed that the residual value of the equipment might be 10 to 20 percent of the original value at the end of the 11th year after the beginning of the lease terms. This estimate seemed conservative to Baker, even recognizing that technologically new IBM equipment would drive the value of old equipment down. In discussions with the Colemans, Baker outlined the possible residual values of the equipment, but felt unqualified actually to predict the residual values, and thus did not do so. William Coleman, who had responsibility within Majestic to evaluate investments, analyzed the proposed transaction, relying solely on Baker's opinion and Majestic's experience with construction deals and used equipment, discussed the deal with his brothers, and entered into the transaction.

On December 19, 1979, Atlantic, "for and in consideration of One Pound (£1) and other good and valuable consideration received," assigned "all of Atlantic's right, title and interest in and to the residual agreements annexed hereto, including all of Atlantic's rights in and to the agreement[s] of lease described therein and the equipment covered thereby," to European Leasing, Ltd. (European), a Liberian corporation. It is unclear from the record how much "other good and valuable consideration" actually passed to Atlantic, and Baker did not, in December 1979, know the actual price of this assignment to European.

On December 26, 1979, several documents pertaining to the instant transaction were executed. Atlantic, European, Carena, and Majestic entered into a sale and purchase agreement whereby,

> SUBJECT as hereinafter mentioned and in consideration of the payment herein provided, European hereby sells, transfers, and assigns to Carena all of Atlantic's Interest in the Equipment. A copy of the Lease[s], as amended is attached hereto together with a copy of the residual agreement[s] (the "Residual Agreement[s]"), made between Atlantic and

> the lessor[s] (the "Lessor[s]") under the Lease[s],[8] ALWAYS PROVIDE THAT:
>
> * * * * * * *
>
> until the Final Date * * *, Carena will not concern itself with the leasi or additional leasing of the Equipment and all liability therefor and benefit therefrom will be for European's account except that, commer ing January 1, 1987 and continuing until and including December 1990 (the "Final Date"), European shall pay, or procure the payment Carena within a reasonable time after the same has been collected, of t following percentages of the net proceeds (as hereafter defined) fro leasing of the Equipment:
>
> | | |
> |---|---|
> | 1987 | 30% |
> | 1988 | 40% |
> | 1989-90 | 50% |
>
> In each case "net proceeds" means gross proceeds actually derived le the reasonable and necessary expenses of remarketing.

The agreement states the purchase price as $95,353, all bu $100 of which was payable contemporaneously with th execution of the agreement, and $100 of which is payable o December 31, 1990. Under the agreement, Atlantic an European warrant to Carena and Majestic, inter alia, tha (1) the lenders own the equipment "free and clear of an claims, liens, charges or encumbrances except for th Lease[s]"; (2) "upon payment of the repurchase price spec fied in the Residual Agreement[s], Atlantic (acting a trustee and agent for European) will acquire title to th Equipment free and clear of any and all claims, lien charges or encumbrances except for the Lease[s]"; and (3 the agreement "is effective to transfer to Carena Atlantic' interest in the Equipment, subject only to the payments [o $95,353], free and clear of all claims, liens, charges o encumbrances." Atlantic agrees to exercise its repurchas rights under the residual agreements, and Atlantic an European agree to "pay or cause to be paid, when due, a debts, liabilities, or obligations secured by liens, claim charges or encumbrances on the Equipment * * * including without limitation, all amounts due and payable by th lessee[s] under the Lease[s] and by Atlantic under th

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[8] Exhibit A to the sale and purchase agreement contains copies of the leases and residu agreements, and some of the invoices, with respect to the equipment.

Residual Agreement[s]." Additionally, the agreement gives European and Atlantic—

> the right to lease the Equipment to others within the United Kingdom until [December 31, 1990]; provided, however, that neither Atlantic nor European will agree to, or cause or permit, any lease, agreement, amendment, extension or other modification of any nature which would affect the Residual Agreement or Atlantic's Interest in the Equipment or which would create any right, title or interest of any other party in the Equipment or any lease thereof after [December 31, 1990], without the prior written consent (which consent shall not be unreasonably withheld or delayed) of [Majestic].

Under the agreement, the risk of loss and damage, and the duty to insure, rest with Atlantic and European.

On the same day, i.e., December 26, 1979, Carena and Majestic executed a purchase agreement whereby—

> Majestic hereby purchases from Carena, and Carena hereby sells, transfers and assigns to Majestic, all of the IBM computers and peripheral equipment (collectively, the "Equipment") described in the lease agreements attached as part of Exhibit A hereto (the "User Leases"), subject and subordinate only to the * * * rights and interests under (a) the User Leases, of the parties thereto, and (b) the Residual Agreement[s], of the Lessor[s] under the User Leases * * * together with all of Carena's right, title and interest in and to the [Sale and Purchase Agreement].

The stated purchase price is $2,055,553, payable as follows: $66,176 by check payable to Leon C. Baker, as attorney; a recourse note for $60,160 (plus $5,053 interest) payable on July 1, 1980; a recourse note for $24,064 (plus $1,444 interest) payable on January 3, 1981; $100 on December 31, 1990; and a nonrecourse note for $1,905,053, secured under a security agreement. The purchase price was based solely on Leopard's representation to Baker of the value of the equipment, which representation Baker had no means of investigating but had reason, based on experience with Mr. Leopard, to find reliable. Under the purchase agreement, Carena warrants to Majestic that (1) "Carena owns Atlantic's Interest free and clear of all liens, charges, claims and encumbrances whatsoever"; (2) "upon the execution and delivery of this Agreement, Majestic will acquire good and marketable title in and to Atlantic's Interest, free and clear of any and all leases, liens, claims and encumbrances of any kind or nature whatsoever"; (3) "except for the User Leases, the Residual Agreements and [the documents executed pursuant to the instant transaction] there are no agreements of any kind, written or oral which affect in any respect the Equipment"; and (4) "upon the exercise of the repurchase option provided for in each Residual Agreement, Majestic, its successors or assigns, will be the owner of the Equipment, free and clear of any lien or encumbrance except the User Lease, if then in effect, and, if then in effect, the interest of lessor under the User Lease." Carena covenants with Majestic to "exercise or cause the exercise of the repurchase option under the Residual Agreements and to pay or cause the payment otherwise than by Majestic of the repurchase price thereunder, promptly upon the expiration of the initial term of the User Leases"; to pay all taxes (other than Majestic's income tax) pursuant to the transaction; and to "pay or cause to be paid, when due, all debts, liabilities, or obligations (collectively 'Debts'), secured by liens, claims or encumbrances on the Equipment, including without limitation, the Encumbrances."[9] Under the heading "Limited Assumptions," the following appears in the purchase agreement:

> Majestic acknowledges that Carena has informed Majestic that the principal financing for purchase of the Equipment from IBM has been provided by the lessors under the User Leases, that the indebtedness to the lessors is secured by legal title to the Equipment and by a right to receive rentals due from users of the Equipment and that Majestic is acquiring the Equipment subject to the title of the lessors and to the right of lessors to receive rentals under User Leases. On or before each December 31 through 1984 Majestic will deliver to Atlantic an assumption agreement in favor of lessors in the form attached as Exhibit B of the following amounts payable to lessors in the subsequent year with respect to Equipment purchased hereunder:[10]

Dec. 31, 1979	$60,000
Dec. 31, 1980	300,000
Dec. 31, 1981	232,000

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[9] The purchase agreement defines the "Encumbrances" as "the rights and interests under (a) the User Leases, of the parties thereto, and (b) the Residual Agreement[s], of the lessor[s] under the User Leases." The "Debts" are defined to include "all sums payable by lessees under the User Lease[s] or subsequent leases covering the Equipment, with respect to which a residual agreement has been entered into, and all sums payable pursuant to such residual agreement, whether or not such sums are payable solely upon the exercise of any purchase or other option thereunder."

[10] A later document, purporting to be the first annual assumption, makes it clear that the "amounts payable to lessors" referred to above are the lessees' obligations under the user leases. See p. 197 *infra*.

Dec. 31, 1982	$212,000
Dec. 31, 1983	200,000

The provision for Majestic's assumption was included in the purchase agreement for purposes of complying with the at-risk requirements in the Internal Revenue Code of 1954, as amended.

The nonrecourse note in the amount of $1,905,053,[11] referred to in the purchase agreement and executed by Majestic on December 26, 1979, provides for interest of 12 percent annually and equal semiannual payments of interest and principal of $158,206 commencing July 1, 1980, with the last payment to be made on January 1, 1991. The note may be prepaid in whole or in part, without penalty, at any time. Carena "agrees to look solely and only to the Equipment and the rights and interests transferred by [Carena] to [Majestic] pursuant to the Purchase Agreement for the payment, performance and observance of all of the obligations of [Majestic], hereunder and [Carena], for itself and its successors and assigns, hereby expressly waives any rights to enforce payment or performance by [Majestic] * * * or its * * * partners." The security agreement referred to in the purchase agreement and in the nonrecourse note, and executed by Carena and Majestic on December 26, 1979, grants to Carena a security interest, subject to the "Encumbrances," see note 9 *supra*, in—

> (a) the interest of [Majestic] in the Equipment and all additions, attachments, accessions and replacements thereto, wherever located and whenever owned or acquired, and all proceeds therefrom, (b) all rentals or other monies payable to [Majestic] under the lease [with Carena] or in connection therewith and (c) all other agreements providing for the sale, lease (including, without limitation, [Majestic's] interest in the User Lease[s] and Residual Agreement[s] referred to in the Purchase Agreement) or other disposition of the Equipment, or its use, and all proceeds and products therefrom (collectively, the "Collateral").

Carena agrees to "look solely and only to the Collateral for the payment and performance" of Majestic's obligations under the note and agreements.

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[11] The note appearing in the record herein is in the amount of $1,905,054, the $1 difference being neither explained nor material.

Also on December 26, 1979, Majestic and Carena ex cuted an agreement of lease, whereby Majestic leased it interest in the equipment back to Carena through Decembe 31, 1990. The agreement fixes rental payments at $158,20 semiannually, commencing July 1, 1980, with the las payment being due on January 1, 1991. In addition beginning January 1, 1987, Carena is to pay Majesti "Contingent Rent" in the amount of the following percent ages of rentals received by Carena under subleases of th equipment, less any remarketing expenses:

1987	30 percent
1988	40 percent
1989	50 percent
1990	50 percent[12]

Under the agreement, Carena bears the risk of loss of the equipment, must maintain and insure the equipment, and must protect and defend Majestic's "title" and interest in the equipment "from and against any and all claims, liens, charges, encumbrances and legal processes of [Carena's] creditors or other persons having claims against [Carena] or the Equipment." Additionally, Carena is given the right to sublease the equipment during the term of the agreement of lease to the lessees under the user leases and, after the completions of the initial lease terms, to any party within the United Kingdom. With the prior written consent of Majestic, which consent is not to be unreasonably withheld or delayed, Carena may agree to modifications and extensions of the user leases and may enter subleases for the equipment having terms extending beyond December 31, 1990.

On December 26, 1979, Majestic executed (l) a nominee agreement whereby it "acknowledges that it holds all rights to the equipment and the lessor's interest in the lease 97 percent for Majestic's account and l percent for the account of each of Arlette Coleman, Carol Coleman and Nancy Coleman," the wives of the Coleman brothers, and (2) a letter to Atlantic, European, and Carena in which Majestic acknowledges, inter alia, that none of the three companies had made any representation concerning its ability to sublease the equipment, the possible rentals receivable after the completion of the initial terms of the leases, or the value, if any, that the equipment will have after December 31, 1990.

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[12] We note that the agreement of lease, apparently as a result of a typographical error, states that "lessor shall pay lessee" these percentages of rentals. Additionally, although the documents would seem literally to require European to allow Carena 30 percent of the 1987 subrental proceeds and Carena to pay Majestic 30 percent of the 30 percent it retained, the context indicates that Carena is to pay over to Majestic the full 30 percent allowed to Carena as between Carena and European. The same analysis applies to the 1988 through 1990 subrentals and the percentages applicable thereto.

By letter to Atlantic dated December 31, 1979, Majestic stated: "Pursuant to our agreement with Carena, we hereby assume payment of lessees' obligations to lessors to you relating to Equipment we have purchased falling due during January 1, 1980 through December 31, 1980 to the extent of $60,000.00. * * * We shall not be required to make any payment hereunder until lessors have exhausted all their remedies against lessees and the Equipment (including sale). We will pay such amount as we are liable to pay lessors hereunder in ten equal installments without interest on each January 1 following determination of the amount of our liability."

The $66,176 portion of the $2,055,553 purchase price stated in the purchase agreement was paid 97 percent by Majestic's check, dated December 26, 1979, for $64,190.72, and 1 percent by petitioner Nancy Coleman's check, also dated December 26, 1979, for $661.76. The two recourse notes, required by the purchase agreement to be delivered to Carena, were, by agreement of December 26, 1979, sold by Carena to the Coleman Capital Corporation Employees Profit Sharing Trust for their discounted value of $44,117. Baker was both a trustee and a beneficiary of such trust. Leopard requested the discounting because of his concern about Majestic's credit. The note having a due date of July 1, 1980, and a face amount of $60,160 plus interest of $5,053 was paid 97 percent by Majestic's check, drawn to Baker's order and dated July 1, 1980, for $63,256.61, and 1 percent by petitioner Nancy Coleman's check, drawn to Baker's order and dated June 30, 1980, for $652.13. The note having a due date of January 3, 1981, and a face amount of $24,064 plus interest of $1,444 was paid 97 percent by Majestic's check, drawn to Baker's order and dated January 2, 1981, for $24,742.76, and 1 percent by petitioner Nancy Coleman's check, drawn to Baker's orde and dated December 30, 1980, for $255.08.[13]

During the years in issue, the used computer market wa volatile. IBM was the dominant supplier of compute equipment to the leasing companies, and its product announcements and introductions had a major impact on use computer values. IBM introduced the first models of th System 370, the series to which the processors involved i the instant transaction belong, in 1971. The System 37 was a half-generation step up from the System 360, which first installed in 1965, was the first integrated family o computer models, allowing upgrades without major reinvestments in peripherals and software. The 370/135 (or 3135 model was introduced in 1971, as initial deliveries of the System 370 were taking place. The 370/138 (or 3138 processor, introduced in 1976, offered a 29- to 36-percent increase in performance, and a 42-percent price cut, over the 3135, and thus effectively replaced the 3135 model on the market. In April 1977, the 303X series of processors was introduced as an interim upgrade in the System 370 series. However, the most profound effect on the market came in January 1979, when IBM announced the 4300 series in the United States and United Kingdom. The 4300 was roughly comparable to the 3135 processor in power, but its announced purchase price was 25 percent of that of the 3135, and maintenance and power costs were expected to be significantly less. Additionally, IBM drastically reduced the price of memory on the 4300 series, and offered an attractive 2-year lease plan.

The peripheral market was less volatile. The 1403-N1 printer was introduced to the market in 1965, and has become a most popular, durable item for IBM. The 3330-1 disk drives were first installed in 1971, and the 3350 direct access storage devices were first delivered in 1976.

Residual values of computer equipment depend on the age and type of the equipment being evaluated. Because the physical qualities of a particular computer remain new due to the replacement of modular units under a maintenance contract, the technological age of the equipment is more important than its physical age; computer obsolescence is less a matter of physical depreciation than of technological innovation. Thus, valuation is based on the announcement and installation dates of the model, rather than the manufacture date of the actual machine in question. Moreover, because peripherals are generally more mechanical than they are electronic, technological obsolescence is less rapid for peripherals than for processors. Generally speaking, then, technological innovations decrease peripheral values less than they do processor values.

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[13] Presumably, the remaining 2 percent of the obligations was paid by the wives of William and Harvey Coleman, each of whom had a 1-percent interest in the transaction.

The markets for used computers in the United States and the United Kingdom involve the same IBM models, but are somewhat different. Computer equipment for the United Kingdom is manufactured for 50-cycle current, while U.K. equipment is manufactured for 60-cycle current. Prices are different in the two countries due to exchange-rate fluctuations and decisions by IBM to cut prices in one country and not the other. Moreover, tax considerations and availability of capital make the leasing business in the two countries somewhat different. However, the markets have recently tended to behave in a more similar manner than in the 1960's and early 1970's. For example, recent product announcements have been simultaneous in the two countries, and dealers have been shipping equipment across the Atlantic Ocean to take advantage of price disparities between the United States and the United Kingdom. It is now possible economically to adapt 50-cycle machinery to 60-cycle current, and vice versa. While shipping, packing, insurance, and the electricity adaptation have a cost, the overseas shipment potential operates to keep IBM from setting widely disparate prices (as a ratio to list price) in the two countries. Generally speaking, residual values in the United Kingdom, as a percentage of list price, track those in the United States.[14]

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[14] There is evidence of some market for used computer equipment in Western Europe and the so-called southern-tier countries in Europe; however, on the record herein, that market cannot be quantified even in macro terms. Moreover, the record herein is unclear as to whether the re-leasing of the equipment outside the United Kingdom was authorized under the various agreements. See pp. 193, 196-197 *supra*.

OPINION

Respondent has mounted a broad attack on petitioners' depreciation and interest deductions relating to certain computer leasing arrangements. Because we are satisfied that the issue of the deductibility of these two items can be resolved within a relatively narrow framework, we see no point in articulating each of the grounds of respondent's attack. We also observe that we have reached our conclusions herein irrespective of the location of the burden of proof, which is upon petitioners with respect to the original deficiencies and upon respondent with respect to the increased deficiencies set forth in his amended answer. To put the matter in a different frame, our holding herein is that, based upon the entire record,[15] petitioners have failed to carry their burden of proof as to the original deficiencies while respondent has, without the benefit of any presumption of correctness, made a prima facie case to sustain the increased deficiencies, and petitioners have failed to produce sufficient countervailing evidence to produce an equilibrium in respect of that prima facie case. See concurring opinion in *Llorente v. Commissioner,* 74 T.C. 260, 273 n. 2 (1980), modified on other grounds 649 F.2d 152 (2d Cir. 1981).

As we see it, the threshold question is whether petitioners had, during 1979 and 1980, a depreciable interest in the equipment. Respondent, taking the leasing arrangements at face value, contends that the lenders, rather than Atlantic, were the owners of the equipment, and concludes that, since Atlantic would thus not be considered as having a depreciable interest, it follows that petitioners, whose interest is derived from that of Atlantic, are not entitled to deductions for depreciation. Petitioners counter with the assertion that the leasing arrangements were nothing more than financing arrangements, with the result that Atlantic was, in substance, the owner of the equipment and thus of a depreciable interest therein, which petitioners in turn acquired by virtue of the transfer to them via European and Carena.

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[15] There is no requirement that we are limited to considering respondent's affirmative evidence in determining whether he has carried his burden of proof. Cf. *Imburgia v. Commissioner,* 22 T.C. 1002, 1014 (1954). See also *Clark v. Commissioner,* 266 F.2d 698, 717 (9th Cir. 1959).

Petitioners rely heavily upon *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), and *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939), to sustain their position—the former because of its doctrine that the determination as to who is entitled to depreciation turns upon an analysis of all the facts relating to the location of the benefits and burdens of ownership, the latter because it adopts the principle that the location of legal title is not in and of itself determinative in respect of the right of depreciation. We have no quarrel with the proposition that the general principles of *Frank Lyon* and *Lazarus* apply to the instant case. Cf. *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985). We part company with petitioners insofar as they contend that these cases require a decision in their favor.

A significant element in determining ownership is the location of title to the property. It cannot be gainsaid that the documentation herein shows that title to the equipment was unconditionally vested in the lenders. Indeed, that result was intended by the parties, i.e., Atlantic and the lenders, not only in form but also in substance in order to achieve the unquestioned objective of providing the lenders with a first year tax deduction of the cost of the equipment under U.K. law. Thus, under U.K. tax law, Atlantic did not have ownership of the equipment. Such being the case, the question arises as to the extent to which petitioners herein can disavow the form of the transaction between Atlantic and the lenders in order to sustain their right to depreciation under U.S. tax law, since it seems clear to us that the sine qua non of petitioners' depreciable interest in the taxable years before us is the existence of a depreciable interest in Atlantic.[16]

We think it important to note that, in the instant case, it is the taxpayer and not the Government which seeks to disavow the form of the transaction. As we observed in

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[16] It is not clear to us on the record herein that it would necessarily follow from a determination that Atlantic was the owner of the equipment for purposes of depreciation during 1979 and 1980, that the various agreements between Atlantic, European, Carena, and Majestic transferred that ownership interest to Majestic. However, for purposes of decision herein, we have ignored the gaps which we perceive in the record in this regard and assumed that any such ownership interest was in fact transferred to Majestic. Indeed, we have ignored the intervention of European and Carena and have assumed that the sale and leaseback herein were, in effect, between Majestic and Atlantic.

Bolger v. Commissioner, 59 T.C. 760, 767 n. 4 (1973): "th taxpayer may have less freedom than the Commissioner t ignore the transactional form that he has adopted." (Citations omitted.) See also *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984); *Sullivan v. United States*, 61 F.2d 1001, 1007 (3d Cir. 1980); *Spector v. Commissioner*, 641 F.2d 376, 381 (5th Cir. 1981), revg. and remanding 7 T.C. 1017 (1979). We think this is particularly true where, as is the case herein, the form of the transaction was adopted by Atlantic and the lenders in order to achieve a bona fide, permissible tax purpose. Cf. *Strick Corp. v. United States*, 714 F.2d 1194 (3d Cir. 1983); *Strong v. Commissioner*, 66 T.C. 12 (1976), affd. without published opinion 553 F.2d 94 (2d Cir. 1977). See also *Ourisman v. Commissioner*, 760 F.2d 541 (4th Cir. 1985), vacating and remanding 82 T.C. 171 (1984). Furthermore, the ability of a taxpayer to avoid the consequences of the form of a transaction is even more restricted in the Third Circuit Court of Appeals to which an appeal in this case would lie. *Sullivan v. United States*, *supra*, which extended the rule of *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), revg. and remanding 44 T.C. 549 (1965). Finally, it is clear that the "strong proof" rule followed by this Court and the more restrictive rule of *Danielson*,[17] apply beyond the confines of allocating payments to a covenant not to compete. *Sullivan v. United States*, *supra* at 1007; *Bradley v. United States*, *supra*; *Spector v. Commissioner*, *supra*; *Miami Purchasing Service Corp. v. Commissioner*, 76 T.C. 818, 830 (1981) (where did title pass from taxpayer to buyer); *Stephens v. Commissioner*, 60 T.C. 1004 (1973), affd. without opinion 506 F.2d 1400 (6th Cir. 1974) (whether taxpayers were legally obligated to buy stock).[18] The fact that the purpose underlying the form of the transactions between Atlantic and the lenders was to take advantage of U.K. rather than U.S. tax laws does not, in our opinion, provide a sufficient foundation for permitting petitioners to disavow that form in order to obtain the benefits of U.S. tax laws. Similarly, we consider it irrelevant that Atlantic and the lenders were apparently not subject to U.S. tax laws. Rather, we think our decision herein should be based upon the situation which would have existed had both Atlantic and the lenders been subject to U.S. tax laws during 1979 and 1980 and sought to claim depreciation in respect of the equipment. Compare *Rochester Development Corp. v. Commissioner*, T.C. Memo. 1977-307, n. 1.

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[17] *Danielson* rejected the "strong proof" standard, to which this Court still adheres (see *O'Callaghan v. Commissioner*, T.C. Memo. 1984-214), in favor of a rule that a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement "would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." See *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), revg. and remanding 44 T.C. 549 (1965).

[18] Our suggestion in *Rochester Development Corp. v. Commissioner*, T.C. Memo. 1977-307, that neither the *Danielson* rule nor the "strong proof" rule applied in determining whether a transaction involved a sale or lease was made in the context of a decision which did "not involve an attempt by petitioner to vary the undertakings set forth in the written agreements."

The bulk of the cases relied upon by petitioners herein involved situations in which the Government was attacking the form of the transaction and the taxpayer was seeking to persuade the Court that the substance and form of the transaction coincided. Certainly this was the posture in *Frank Lyon Co. v. United States, supra*, and *Estate of Thomas v. Commissioner, supra*, and consequently, taking into account other factors to which we will subsequently advert, those cases are readily distinguishable from the situation in the instant case. See *Bradley v. United States, supra* at 720. Moreover, there is nothing in either *Frank Lyon* or *Thomas* which compels us to ignore the form of a transaction structured to obtain tax benefits in one jurisdiction and to restructure the transaction, at the insistence of the taxpayer, in order to confer tax benefits in another jurisdiction—in short, to enable the taxpayer to play both ends against the middle. Although *Helvering v. F. & R. Lazarus & Co., supra*, ostensibly stands for the proposition that a taxpayer can attack the form of a transaction which encompasses the passage of title, there were various other factors present in that case which the Supreme Court considered significant in reaching its conclusion and on which we will subsequently comment. Moreover, we think it important that, in permitting the taxpayer to attack the form of the transaction, the Supreme Court in *Lazarus* did not hold that the location of title was irrelevant. *Bowen v. Commissioner*, 12 T.C. 446 (1949), and *Oesterreich v. Commissioner*, 226 F.2d 798 (9th Cir. 1955), revg. a

Memorandum Opinion of this Court, are similarly factually distinguishable. The same is true of *Bolger v. Commissioner, supra*, where respondent conceded any issue of depreciation based on nonrecognition of the leases. See 59 T.C. at 767.

In light of the foregoing analysis, we conclude that the proper posture of this case is that the unconditional and consistently confirmed vesting of title in the lenders for a bona fide purpose creates a situation in which respondent has made a prima facie case that Atlantic was not the owner of the equipment for purposes of depreciation, and in which petitioners, claiming through Atlantic, should not be in a better position since, under the various agreements, Majestic simply acquired Atlantic's interest in the equipment. In so concluding, we emphasize that we are not holding that Atlantic was not the owner of the equipment, but only that petitioners have the burden of producing, at a minimum, "strong proof" that the other elements of the burdens and benefits of ownership were such that Atlantic should be considered the owner and, additionally, that Majestic assumed such burdens and was entitled to such benefits of ownership with the result that it (and therefore petitioners) should be entitled to depreciate its (and their) investment[19] in the equipment irrespective of any ownership by Atlantic. Absent such "strong proof," petitioners must be held to have failed to carry their burden of proof as to the original deficiencies and respondent must, by virtue of the prima facie case stemming from the location of title, be held to have carried his burden of proof as to the increased deficiencies. Cf. *Whitmer v. Commissioner*, 443 F.2d 170 (3d Cir. 1971), affg. a Memorandum Opinion of this Court. See also Gideon, "Mrs. Gregory's Grandchildren: Judicial Restrictions of Tax Shelters," 5 Va. Tax Rev. 825 (1986). It is to these other elements of the benefits and burdens of ownership that we now turn our attention.

We recognize that, according to the tabulation on page 186, Atlantic obtained some $55,000 less than the original cost of the equipment from the lenders and that this indicates a financing rather than a sale transaction. But, given the difficulties in computing the costs of the equipment to Atlantic, as reflected in the notes to the tabulation on page 186 *supra* (see p. 187 *supra*) and the small magnitude of this differential in relation to the overall cost of the equipment (approximately 3 percent), we are not prepared to attach much significance to this circumstance.[20] Certainly, this differential is a far cry from the approximately 50 percent differential which was present in *Helvering v. F. & R. Lazarus & Co., supra.*

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[19] For convenience, we sometimes use Majestic alone as the focal point for purposes of analysis, although a small part of petitioners' interest is separate and distinct from their interest in Majestic. See pp. 196-198 *supra*.

The terms of all the initial leases extended beyond the taxable years involved herein and the leases were net leases, which placed the full responsibility for the equipment and its maintenance, except for wear and tear, upon the lessees. Thus, neither Atlantic nor any entity deriving its interest from Atlantic bore most of the normal burdens of ownership. While we recognize that net leases of the type involved herein are common in the business world and, in and of themselves, do not control the question of who is entitled to depreciation (see *Estate of Thomas v. Commissioner*, 84 T.C. at 433; *Northwest Acceptance Corp. v. Commissioner*, 58 T.C. 836 (1972), affd. per curiam 500 F.2d 1222 (9th Cir. 1974)), we think that, in the context of this case, it is an element that may properly be taken into account in determining whether petitioners had a depreciable interest in the equipment during the years in issue. Moreover, we note that the purchase and sale agreement among Atlantic, European, Carena, and Majestic made clear that Majestic had no responsibility for maintaining or replacing the equipment.

Atlantic had assigned the rents under the leases to the lenders without recourse. Thus, aside from the fact that Atlantic's right to reacquire title to the equipment from the lenders upon the completion of the initial lease terms was conditional on payment by the lessees of all amounts due under such leases, Atlantic had no liability to the lenders for the payment of such amounts prior to undertakings resulting from the transactions involved herein. The first time a recourse liability to the lenders on the part of Atlantic could possibly be said to exist would be upon the execution of the purchase and sale agreement, thereby permitting the lenders to be considered third-party beneficiaries of Atlantic's obligations thereunder to pay or cause to be paid the debts encumbering the equipment, including amounts due from the leases. Although such liability was partially offset by Majestic's "assumption" agreement with Carena, we view this as a mere sharing in the newly created undertaking with respect to the rents. At best, the "assumption" was Majestic's guaranty to make good any default by a lessee under an initial lease.[21] Cf. *Brand v. Commissioner*, 81 T.C. 821 (1983). Indeed, Baker's testimony at trial clearly indicates that the "assumption" agreement was designed simply to enable the transaction to meet the "at risk" requirements under section 465.[22] See *Tolwinsky v. Commissioner*, 86 T.C. 1009 (1986); *Law v. Commissioner*, 86 T.C. 1065 (1986). Under the foregoing circumstances, these obligations, in our opinion, do not represent any present investment in the equipment by either Atlantic or Majestic, irrespective of any third-party beneficiary rights that may thereby have been created in the lenders.

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[20] The tabulation on p. 186 *supra* shows that, in the case of some of the equipment, Atlantic got an excess over cost from the lenders, while, with respect to some equipment, Atlantic got less than cost from the lenders. These disparities are unexplained on the record; since the parties attach no importance to these disparities, we do likewise.

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[21] It is clear to us that the lenders viewed the lessees as financially responsible entities and the equipment as sufficient security that those responsibilities would be duly discharged. We are satisfied that neither Atlantic nor Majestic had any reason to believe otherwise, and that Atlantic simply viewed Majestic's assumption as security for its effective second-mortgagee position behind the lenders in the unlikely event that the lessees were to default under their leases. Indeed, Majestic's "assumption" became operative only after all remedies against the lessees and the equipment had been exhausted by the lenders. Moreover, the "assumptions" were to be given in separate amounts year by year, and it appears that the amounts covered by the "assumptions" were to be paid, if at all, over a 10-year period without interest. Clearly, a promise to pay in future installments a liability of another that becomes immediately due and payable can hardly be characterized as anything more than a guaranty.

[22] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

At the trial of the instant case, Baker testified as follows:

"In order to comply with the at-risk requirements, which were introduced about that time, the documents provided—I'm going to say this was done with the at-risk requirements in mind. They could not, in compliance with the statute, assume—assumption of personal liability on the nonrecourse mortgage wouldn't have availed any because the nonrecourse mortgage was held by [Carena]. So, therefore, assumption of liability on that nonrecourse mortgage would not have satisfied the requirements of the statute. Therefore, they undertook to assume a portion of the underlying liability. * * * And they assumed sufficient amounts of that liability to comply with the at-risk requirements."

We do not view the various December 1979 agreements as otherwise establishing any depreciable interest in Atlantic during the years at issue, which could be said to have been conveyed to Majestic. In fact, the structure of those agreements points in the opposite direction. If one looks at the right of Majestic to participate in future rentals, it is obvious that Atlantic continued to have the right to all rentals obtained after the completion of the terms of the initial leases through 1986.[23] After 1986, Majestic was entitled to receive "contingent rent" in amounts of 50 percent or less of such rentals through 1990. Thus, Majestic was a nonparticipant in the rents for several years after the years at issue and then only an "iffy" semi-participant for another 4 years. Certainly the situation herein is a far cry from that which existed in *Estate of Thomas v. Commissioner, supra*, where the parties stipulated that the useful life of the equipment extended at least 3 years beyond the lease terms—a fact which this Court considered quite significant. See 84 T.C. at 433. Under the circumstances, it is difficult to embrace the concept that Majestic's participation in future rentals provides a basis for holding that Majestic had a depreciable interest in the equipment during the taxable years at issue.

Nor do we view the leaseback from Majestic to Carena as indicating that Majestic either held a depreciable interest in the equipment in 1979 and 1980 or made any investment in the equipment beyond the $150,500 it paid in cash and recourse notes for an interest in the residuals at a future date. While we are cognizant that the identity between the amounts of the lease payments by Carena to Majestic and the nonrecourse debt payments by Majestic to Carena does not preclude separate recognition of the lease and the indebtedness (see, e.g., *Estate of Thomas v. Commissioner*, 84 T.C. at 436), we think it appropriate, in the context of determining whether petitioners acquired an interest in the equipment depreciable in 1979 and 1980, to view those offsetting payments as canceling each other and therefore properly to be ignored in determining the nature of the acquired interest. In this connection, we note that, in *Frank Lyon*, the obligation of the lessor for whose benefit the rental payments were made to the financing institutions was a *recourse* obligation. While the comparable obligation in *Estate of Thomas* was nonrecourse, there were other factors in that case which make it distinguishable from the case before us (see p. 207 *supra* and note 39 *infra*).

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[23] Petitioners seek to minimize the impact of this element by arguing that we should view the agreement as transferring all Atlantic's rights to Majestic and then leasing this right back from Majestic. While we have assumed that the transaction constituted a sale and leaseback between Majestic and Atlantic (see note 16 *supra*), we view as mere semantic sophistry the suggestion that the agreements, though literally reserving for Atlantic a right to future income, actually transferred this right to Majestic from Atlantic and then transferred it back to Atlantic.

As far as the $150,500 is concerned, this too did not, in our opinion, create an interest depreciable by Majestic during the taxable years at issue. It was clearly paid for the right to participate in the contingent benefits hopefully to be derived from the future use of the equipment at a point of time when that use was at best speculative in view of the maximum residual value of the equipment.[24] See p. 212 *infra*.

On the basis of all of the above, and of the entire record herein, we hold that Majestic, and thus petitioners, did not own an interest in the equipment depreciable in 1979 and 1980. It may well be that the interest will ripen into a depreciable interest, perhaps as early as 1987, but this is an issue which we need not and do not decide. See and compare *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764, 770-774 (1977), affd. per curiam 622 F.2d 995 (9th Cir. 1980); *Davis v. Commissioner*, 66 T.C. 260 (1976), affd. 585 F.2d 807 (6th Cir. 1978); *Commissioner v. Moore*, 207 F.2d 265, 268-269, 271-272 (9th Cir. 1953), revg. 15 T.C. 906 (1950); *Fox River Paper Co. v. Commissioner*, 28 B.T.A. 1184, 1203-1204 (1933); sec. 167(h); see also Rev. Rul. 60-180, 1960-1 C.B. 114; Note, "Purchaser's Depreciation Rights in Property Subject to a Lease," 82 Mich. L. Rev. 572, 582-588 (1983). But cf. *Wagner v. Commissioner*, 518 F.2d 655 (10th Cir. 1975), revg. and remanding a Memorandum Opinion of this Court. In view of this holding, we need not address the other major contentions of the parties relating to the existence of a profit motive under section 183—an element which does not affect the issue of interest deductions to which we now turn our attention. See sec. 183(b)(1).

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[24] We have not taken Majestic's "assumption" into account for the reasons previously stated. See p. 206 *supra*.

The next issue for decision is whether respondent properly disallowed petitioners' deduction of interest on the nonrecourse note. Section 163(a) provides for the deductibility of "all interest paid or accrued within the taxable year on indebtedness," and it is well established that deductible interest is a payment for the use or forbearance of money. *Deputy v. du Pont*, 308 U.S. 488, 497 (1940); *Smith v. Commissioner*, 84 T.C. 889, 897 (1985). It is also well settled that the "indebtedness" referred to in section 163(a) must be a *genuine* indebtedness. *Knetsch v. United States*, 364 U.S. 361 (1960); *Elliott v. Commissioner*, 84 T.C. 227, 244 (1985), affd. 782 F.2d 1027 (3d Cir. 1986). While transactions such as petitioners' generally receive scrutiny on this score due to the "obvious opportunities for trifling with reality"(*Elliott v. Commissioner, supra* at 244), neither the nonrecourse note nor the use of the sale-leaseback device in which rent payments are geared to interest and amortization on the note necessarily deprives the debt of its character as genuine indebtedness able to support an interest deduction. See *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976), affg. 64 T.C. 752 (1975); *Hilton v. Commissioner*, 74 T.C. 305, 348 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982). However, where, in such situations, the purchase price and principal amount of the nonrecourse note unreasonably exceed the value of the property interest acquired,[25] it is settled that no genuine indebtedness exists. *Estate of Franklin v. Commissioner, supra* at 1049; *Elliott v. Commissioner, supra* at 245; *Odend'hal v. Commissioner*, 80 T.C. 588, 616 (1983), affd. on this issue 748 F.2d 908 (4th Cir. 1984). This is true because "the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged." *Estate of Franklin v. Commissioner, supra* at 1049. The economics of such a transaction, then, are such that only a potential that a genuine indebtedness may arise exists, and thus that the purchaser has not secured the requisite "use or forbearance of money." *Estate of Franklin v. Commissioner, supra* at 1049.

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[25] Compare *Brannen v. Commissioner*, 78 T.C. 471, 493 (1982), affd. 722 F.2d 695 (11th Cir. 1984) (purchase price) with *Hager v. Commissioner*, 76 T.C. 759, 774-775 (1981) (principal amount). See also *Elliott v. Commissioner*, 84 T.C. 227, 245 n. 5 (1985), affd. 782 F.2d 1027 (3d Cir. 1986).

The starting point of our analysis is the residual value of the equipment, i.e., the value of the interest acquired. The parties' expert witnesses at trial varied widely in their estimates of residual value. Each purporting to rely only on knowledge available in 1979, respondent's experts, Dee Morgan and S. Paul Blumenthal, predicted 1987 values of $13,000 and $37,500, respectively, whereas petitioners' experts, Davies and David McCormick, predicted 1987-91 values of Majestic's interest in the equipment totaling $393,023 and $337,941, respectively. Based upon the totality of the testimony and expert reports, we find that, of the parties' expert witnesses, McCormick was the most knowledgeable about the U.K. computer leasing market, prepared the clearest, most systematic analysis of the value of Majestic's interest in each of the years 1987-91, and was generally the most convincing. Thus, we begin our analysis of the value of the interest purchased by Majestic with McCormick's figures.

McCormick, the president of ICA Europe, a computer leasing company that competes with Atlantic, estimated the equipment's residual values, in terms of percentages of the 1979 IBM prices, as follows:

Lease	*1987*	*1988*	*1989*	*1990*	*1991*
(1) Reuters	10	0	0	0	0
(2) Northumberland	10	0	0	0	0
(3) Thomson Travel	0	0	0	0	0
(4) Torrington					
Processor	0	0	0	0	0
Printer	23	23	20	20	10
(5) Cheshire	35	35	25	25	15
(6) Cheshire	20	20	10	10	10
(7) Cheshire	40	40	30	30	20
(8) C & J Clark	25	25	20	20	10

By our calculation, given Majestic's contractual percentages of the 1987-90 rentals, McCormick's assertions as to 1979 IBM prices, and an exchange rate of $2.216/£,[26] Mc

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[26] As is obvious in 1986, when the exchange rate is approximately $1.55/£, this rate turns out to be totally unrealistic. In the absence of a more reasonable indication of the predicted future exchange rates that would have been used by an objective analyst in December 1979, however, we use $2.216/£ in our calculation.

Cormick's residual percentages result in cash-flows to Majestic as follows:

1987	*1988*	*1989*	*1990*	*1991*	*Total*
$44,732	$41,523	$37,083	$37,083	$115,443	[27]$275,864

An objective analysis of the totality of the record leads us to conclude that even this lower estimate of the value of Majestic's interest is substantially skewed upward. Mc Cormick testified that he based his estimates of residual value primarily on two factors: (l) The historical value of IBM equipment, and (2) Atlantic's position in the U.K. leasing market. With regard to the first of these factors, we find that, while McCormick's testimony that the longevity of the earlier System 360 processors and 2311 disk drives made it reasonable in 1979 to predict that the processors would last 10 years and the peripherals 15 years, was internally logical, McCormick failed sufficiently to take into account the 1978 announcement rumors and IBM price cuts as to disk drives and, more importantly, IBM's January 1979 announcement and late-1979 delivery of the 4300 series. To be sure, some skepticism as to the magnitude of the 4300's price-performance improvement over the System 370 models appears to have been warranted. But, given the experts' testimony and reports, we find that McCormick focused excessively on the historical data and insufficiently on the objective indicia in 1979 of a severe flattening of the market for the processors and peripherals comprising the equipment. We conclude that, *at a minimum*, McCormick's figures (as corrected) must be reduced by a factor of 20 percent on this ground.

With regard to the second factor—Atlantic's market position—we find we must again discount McCormick's figures. McCormick's testimony emphasized that Atlantic's unique position in the leasing market allows it to derive higher residuals than are generally obtainable from computer equipment.[28] The testimony of Davies and McCormick

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[27] We note that respondent, correcting McCormick's mathematical errors, arrived at a total value of $274,682, and that our calculation further corrects the parties' errors.

[28] For example, McCormick testified:

"In 1979, whereas a normal company * * * would write a normal contract, say for 3 years or 4 years [or] 5 years [and] might expect to have a 37138 last 8 years from the date of first delivery, in Atlantic's case they well expected [them] to last 10 years because they had a indicates that this advantage translates into residual values for Atlantic that are 20 percent higher, and equipment lives that are 25 percent longer, than the average in the brokers' market. To be sure, based upon our assumptions as to the proper parties to the sale-leaseback transaction (see note 16 *supra*), Atlantic stood to benefit from the re-leasing of the equipment after the expiration of the initial terms, either from the right to retain 100 percent of the rents therefrom or a 70 percent to 50 percent share through 1990 (see p. 192 *supra*). But by that time, Atlantic's debt to the lenders and undertaking to Carena will presumably be completely satisfied (see note 21 *supra*), so that Atlantic's obligation to pay the rentals due from the initial leases could hardly be said to constitute a means of prodding Atlantic to engage in releasing activities. Nor, given the other evidence of record, are we persuaded that, whatever Atlantic's unique position may have been, it would have or could have successfully utilized that position as McCormick testified. Baker, at best, gave the back of his hand to the elements of contingent rentals and residual value. See p. 185 *supra*. Consequently, to the extent that McCormick took Atlantic's remarketing ability into account in deriving his estimates, such estimates are too high. We are satisfied that a further reduction of McCormick's figures by a factor of *at least* 20 percent is appropriate.

Thus we conclude that, in his calculations, McCormick erred by adding at least 40 percent to the proper 1979 estimate of the value of Majestic's interest in the equipment. Accordingly, we are left *at the very most* with the following cashflows and total residual value for Majestic:

1987	*1988*	*1989*	*1990*	*1991*	*Total*
$31,951	$29,659	$26,488	$26,488	$82,459	[29]$197,045

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customer base tied in, because they had an outstanding relationship with that customer base, and they had a very, very good reputation in the market."

[29] Here, again, the instant situation is significantly different from that which existed in *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985), where the parties stipulated to a residual value of at least 14 percent based on original cost. See 84 T.C. at 429. We are constrained to note that the factual foundation for the above numerical findings may be too favorable to petitioners, at least to the extent that it rests on an implied finding that the equipment subject to the initial leases will have useful lives extending beyond 1986.

Without question, this *maximum value* of Majestic's interest of $197,045, when compared with either the $2,055,553 stated purchase price or the $1,905,053 nonrecourse note, establishes that the price and note unreasonably exceed the value of the interest acquired by Majestic. See, e.g., *Elliott v. Commissioner*, 84 T.C. at 246 (maximum value of $7,800, note for $198,000, price of $235,000); *Fuchs v. Commissioner*, 83 T.C. 79, 102 (1984) (maximum value of $42,000, note for $687,500, price of $812,500); *Dean v. Commissioner*, 83 T.C. 56, 78 (1984) (maximum value of $58,500, note for $742,500, price of $877,500); *Odend'hal v. Commissioner*, 80 T.C. at 617 (maximum value of $2 million, note for $3,920,000, price of $4 million). Thus, respondent correctly disallowed petitioners' deductions for interest on the nonrecourse note.[30]

Finally, we hold that the interest on the *recourse* promissory note paid by Majestic and petitioner Nancy Coleman in 1980 is deductible under section 163(a). It is clear that petitioner Nancy Coleman deducted her share of such interest on her 1980 return, and we presume that the interest deducted on Majestic's 1980 return includes its share of the interest on the recourse note. Additionally, although he appears to have disallowed deductions for such interest in the deficiency notice, respondent does not argue in this proceeding that such interest was not properly deducted. From all that appears in the record herein, the note was genuine, recourse indebtedness, and the interest paid thereon in 1980 is thus deductible. In order to account for the allowance of these deductions,

Decision will be entered under Rule 155.

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[30] We note that this analysis also provides further support for our holding that, at the very least, the bulk of the depreciation deductions herein were properly disallowed. See, e.g., *Odend'hal v. Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), affg. on this issue 80 T.C. 588 (1983); *Brannen v. Commissioner*, 722 F.2d 695, 701 (11th Cir. 1984), affg. 78 T.C. 471 (1982); *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048-1049 (9th Cir. 1976), affg. 64 T.C. 752 (1975). In this connection, we further note that our decision in *Estate of Thomas v. Commissioner*, *supra*, emphasized that it was stipulated and proved that the equipment had substantial value beyond the terms of the leases subject to which the taxpayer acquired such equipment.

CASANOVA COMPANY, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 25468-84. Filed July 28, 1986.

P seeks exemption from the withholding requirements of secs. 1441 and 1442, I.R.C. 1954, based upon treaty provisions between the United States and the Netherlands and R's applicable regulation, and based upon exemption documents applicable to the period in question. R, while conceding the authenticity of the documents, contends that they are ineffective because filed late. Upon cross-motions for summary judgment: *Held*, that there are no material facts in dispute, and the case may be decided as a matter of law. *Held, further*: That the documents are valid to confer exemption under existing law. Summary judgment for P granted.

Alan F. Segal, for the petitioner.

Andrew P. Fradkin and *Thomas J. Kane*, for the respondent.

OPINION

KÖRNER, *Judge*: Respondent determined that petitioner was liable for a deficiency of $172,500 in income tax required to be withheld for the calendar year ending December 31, 1980, together with additions to tax under section 6653(a)[1] in the amount of $8,625, and a further addition to tax under section 6656 in the amount of $8,625. The issues presented are:

(1) Whether petitioner was required to withhold income tax at the source on certain income paid to a foreign entity in 1980, pursuant to sections 1441, 1442, and/or applicable treaty provisions;

(2) If petitioner was liable to make such withholding, whether petitioner's failure to withhold subjects it to additions to tax under section 6653(a); and

(3) If petitioner was liable to make such withholding, whether petitioner is further liable for a 5-percent addition

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

to tax under section 6656, for failing to make deposits of tax withheld.

Petitioner is a partnership whose address at the time of filing the petition herein was in Chicago, Illinois. The relevant returns for the year in issue were filed with the District Director of Internal Revenue at Chicago, Illinois.

After the case was at issue, respondent commenced pretrial discovery and served on petitioner certain interrogatories and a request for production of documents, on or about February 7, 1985. No response having been received from petitioner, respondent on July 5, 1985, moved the Court for orders compelling petitioner to respond to respondent's interrogatories and request for production of documents.

On August 12, 1985, and before the Court had taken any action on respondent's motions, petitioner filed a response thereto, indicating that certain documents had been supplied to respondent which rendered respondent's motions moot. Respondent, while agreeing that the documents supplied were responsive to certain of his requests, reported to the Court on September 16, 1985, that petitioner's response was incomplete, that substantial legal and factual questions remain in the case, and prayed the Court to order full compliance with his requested discovery.

Respondent's motions were calendared for hearing at Chicago, Illinois, on November 12, 1985.

On November 6, 1985, petitioner filed a motion for summary judgment herein, together with supporting documents. Said motion was also calendared for hearing at Chicago, Illinois, on November 12, 1985. On that date, respondent filed a motion to strike petitioner's motion for summary judgment, or, in the alternative, to deny it, on the grounds that no competent evidence had been adduced, within the meaning of Rule 121, to support the motion. At the hearing on November 12, 1985, however, petitioner tendered and the Court accepted, as further attachments to petitioner's motion, certain relevant documents covered by appropriate affidavit, pursuant to Rule 121(d).

Both petitioner's motion for summary judgment and respondent's motions to enforce discovery were heard on November 12, 1985. Thereafter, respondent filed his cross-motion for summary judgment, with memorandum in support thereof and in opposition to petitioner's motion for summary judgment, together with documents supported by affidavit; petitioner filed a brief in opposition to respondent's cross-motion for summary judgment, together with supplementary documents supported by affidavit; and respondent filed a supplementary or reply memorandum in support of his motion.

The case is before us in this posture. We will address the cross-motions for summary judgment first.

The Court's rule with respect to summary judgment motions, Rule 121, is derived in large part from Rule 56 of the Federal Rules of Civil Procedure. See notes to the Court's new Rules of 1974, 60 T.C. 1057, 1126, et seq. As relevant herein, Rule 121 provides as follows:

> RULE 121. SUMMARY JUDGMENT
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> (a) General: Either party may move, with or without supporting affidavits, for a summary adjudication in his favor upon all or any part of the legal issues in controversy. Such motion may be made at any time commencing 30 days after the pleadings are closed but within such time as not to delay the trial.
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> (b) Motion and Proceedings Thereon: The motion shall be filed and served in accordance with the requirements otherwise applicable. See Rules 50 and 54. An opposing written response, with or without supporting affidavits, shall be filed within such period as the Court may direct. A decision shall thereafter be rendered if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. A partial summary adjudication may be made which does not dispose of all the issues in the case.
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> (d) Form of Affidavits; Further Testimony; Defense Required: Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or filed therewith. The Court may permit affidavits to be supplemented or opposed by answers to interrogatories, depositions, further affidavits, or other acceptable materials, to the extent that other applicable conditions in these Rules are satisfied for utilizing such procedures. When a motion for summary judgment is made and supported as provided in this Rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this

Rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, a decision, if appropriate, may be entered against him.

The party moving for summary judgment has the burden of demonstrating that no genuine issue as to any material fact exists, and that he is entitled to judgment as a matter of law. *Adickes v. Kress & Co.*, 398 U.S. 144, 157 (1970); *Gulfstream Land & Development v. Commissioner*, 71 T.C. 587, 596 (1979). The facts relied upon by the moving party must be viewed in the light most favorable to the opposing party so that any doubt as to the existence of a genuine issue of material fact will be resolved in favor of denying the motion. *Adickes v. Kress & Co., supra*; *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962). Nevertheless, the motion must be granted if the Court is satisfied that no real factual controversy is present so that the remedy can serve "its salutary purpose in avoiding a useless, expensive and time consuming trial where there is no genuine, material fact issue to be tried." *Lyons v. Board of Education of Charleston*, 523 F.2d 340, 347 (8th Cir. 1975). Finally, the party opposing summary judgment may not simply rest upon the mere allegations or denials of his pleading; his response, by affidavit or otherwise, must set forth more specific facts showing there is a genuine factual issue for trial. Rule 121(d). Whether or not facts are *material*, of course, depends upon the context in which they are raised and the legal issues which exist between the parties.

The controversy between the parties in this case involves the liability of petitioner to withhold U.S. income tax on payments of interest to a foreign entity.

Section 881(a) imposes a tax at the rate of 30 percent on amounts received from U.S. sources by foreign corporations, to the extent that those payments are not effectively connected with the conduct of a trade or business within the United States. Section 861(a)(1), in turn, provides that interest on certain obligations of residents of the United States is treated as income from sources within the United States for income tax purposes.

Section 1441, in general, requires U.S. persons to withhold U.S. income tax at the rate of 30 percent on payments of certain types of income to nonresident aliens. Such income includes interest, section 1441(b). In like manner, section 1442 requires the same type of withholding, and at the same rate, with respect to such income which is paid to foreign corporations. Section 1461 imposes personal liability for such tax on every person required to withhold the same. Such statutory withholding agents are required to make annual returns to the Internal Revenue Service of all income as to which withholding is required, including any income which is exempted from withholding by reason of any treaty between the United States and a foreign country. The required annual returns are to be made on Form 1042 (U.S. Annual Return Of Income Tax To Be Paid At Source), and Form 1042S (Income Subject To Withholding Under Chapter 3, Internal Revenue Code). Sec. 1.1461-2, Income Tax Regs.

In order to recognize and accommodate special treaty provisions which may exist between the United States and foreign countries regarding the taxation and the withholding of income tax on certain types of income, section 1.1441-6, Income Tax Regs., as in effect for 1980, provides in pertinent part:

> (a) In general. The rate of 30 percent or 14 percent shall be reduced as may be provided by a treaty with any country. * * * In case of payments on or after January 1, 1972, of any of the items specified in sec. 1.1441-2 (other than dividends), the requirements of paragraphs (b) and (c) of this section shall apply in lieu of the ownership certificate or the exemption (or reduced rate) certificate (or corresponding letter) required by the regulations under the various income tax conventions in effect to which the United States is a party.[2]
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> * * * * * * *
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> (c) Income other than coupon bond interest or dividends. (1) To secure the reduced rate of, or exemption from, United States income tax at source in case of items of income specified in sec 1.1441-2 other than coupon bond interest and dividends, the recipient shall, if entitled to such treatment pursuant to a tax convention, file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) with the withholding agent. This form shall be completed and signed by either the owner of the income, his trustee, or his agent, and shall include such information as is required by the form and accompanying instructions. A separate Form 1001 shall be used for each type of income. For this purpose, all income from a trust, estate, or investment account shall be considered as a single type of

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[2] The quoted language thus supersedes, pro tanto, the provisions of sec. 505.304, Regulations under Tax Conventions.

> income. Each form shall also contain a statement that the owner of the income is entitled to a reduced rate of, or exemption from, tax pursuant to a tax convention. If, after filing such form, the owner ceases to be eligible for the benefits of the tax convention for such income, he shall promptly notify the withholding agent by letter.
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> (2) Form 1001 shall be effective for the successive 3-calendar-year period during which the income to which the form applies is paid. *Each such form filed with any withholding agent shall be filed as soon as practicable.* Once a form has been filed for a type of income (other than coupon bond interest) with respect to such a 3-year period, no additional Form 1001 for such income need be filed with respect to such period unless the Commissioner of Internal Revenue notifies the withholding agent that the taxpayer shall file another form. If any change occurs in the ownership of income subject to a Form 1001 recorded on the books of the withholding agent, the Form 1001 shall no longer be effective. The Form 1001 shall be retained by the withholding agent for at least 4 years after the end of the last calendar year in which income subject to the form is paid. [Emphasis supplied.]

Effective on January 1, 1947, there came into effect an Income Tax Convention between the United States and the Kingdom of the Netherlands, T.I.A.S. 1855, 62 Stat. 1757 (hereinafter referred to as the Convention). Article VIII of the Convention provides in pertinent part as follows:

> (1) Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness), other than interest referred to in Article V of the present Convention [not here relevant] derived from sources within the United States by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment, shall be exempt from United States tax; but such exemption shall not apply to such interest paid by a United States corporation to a Netherlands corporation controlling, directly or indirectly, more than 50 percent of the entire voting power in the paying corporation. [62 Stat. 1761.]

The above-quoted portion of the Convention was amended by a supplementary convention between the two nations, effective July 8, 1966, but such amendment was not made applicable to the Netherlands Antilles, so that the original provision, quoted above, remains in effect with respect to that territory.

Effective September 28, 1964, the two nations adopted a Protocol extending and modifying the provisions of the Convention with respect to the Netherlands Antilles. In pertinent part, article I of the Protocol provides:

> (2) Notwithstanding the provisions of paragraph (1) of the present Article, Articles VII, VIII and IX of the Convention shall continue to apply to dividends, interest, and royalties derived by any entity, to which the provisions of paragraph (1) of this Article would otherwise apply, if either
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> (a) the payer of such income is a United States corporation (other than a United States corporation, 60 percent or more of the gross income of which is derived from interest except to the extent derived by a corporation the principal business of which is the making of loans, dividends, royalties, rents from real property, or gain from the sale or other disposition of stock, securities, or real property), 25 percent or more of the stock of which is owned by such entity; or
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> (b) all of the stock of such entity is owned
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> (i) solely by one or more individual residents of the Netherlands Antilles in their individual capacities,
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> (ii) solely by one or more individual residents of the Netherlands in their individual capacities, or
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> (iii) solely by one or more corporations of the Netherlands [T.I.A.S. 5665, 15 U.S.T. 1902.].

For purposes of the present cross-motions for summary judgment, the following relevant and material facts are deemed to be established in this record by the pleadings, the affidavits of the parties, and other acceptable materials, pursuant to Rule 121(b).

Petitioner, for the year 1980, duly filed Forms 1042 and 1042S with respondent, in which petitioner reported the payment of $575,000 of interest in that year to Laatam, N.V., a Netherlands Antilles corporation, on which no U.S. income tax was withheld, based upon petitioner's claim of exemption under the Convention and the Protocol.

Upon audit, respondent determined a deficiency of income tax withholding against petitioner with respect to the above interest payment, in the amount of $172,500, together with statutory additions for negligence under section 6653(a), in the amount of $8,625, and a further addition under section 6656 for failure to make deposit of withheld taxes, in the amount of $8,625. The basis for said determination was stated by respondent in his statutory notice of deficiency as follows:

> Explanation of Deficiency
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> It is determined that Casanova Company filed Form 1042 (U.S. Annual Return of Income Tax To Be Paid At Source) for 1980, reporting payments of $575,000.00 in interest to Laatam N.V. Wilemstaad No 10 A

Curacao Netherlands Antilles. The rate of withholding was shown as zero, and no tax was withheld by Casanova Company.

Casanova Company has not verified or produced Form 1001 (Ownership, Exemption or Reduced Rate Certificate) or produced Forms VS-3 or VS-4 from the recipient of the interest payments, and therefore Casanova Company does not meet the requirements necessary to qualify for an exempt rate of withholding. Accordingly, a 30 percent rate of withholding is applied to the income subject to withholding, $575,000.00 and there is determined to be a deficiency of $172,500.00 for 1980.

In its petition filed herein, petitioner alleged error as to said determinations of respondent, and alleged that it had met or would meet the necessary requirements for exemption. Respondent's answer was a general denial.

As supplements to their respective motions for summary judgment, each party proffered and relies upon the following two documents:[3]

A. Treasury Form 1001 (Ownership, Exemption or Reduced Rate Certificate) filed by Laatam, N.V., with petitioner as its withholding agent, and certifying that it (Laatam) qualified for reduced or exempt rate of tax for the years 1979, 1980, and 1981. Such document was dated October 4, 1984.

B. Form VS-4, a certificate issued by the Government of the Netherlands Antilles, and issued for the purpose of filing with the U.S. Treasury Department, certifying that Laatam, N.V., is a corporation organized in the Netherlands Antilles, and all of whose stock is owned by Dutch interests within the meaning of article I(2)(b) of the Protocol of 1964 (quoted above herein). Said certificate was dated October 3, 1984, and is effective for a 3-year period beginning on June 1, 1979.

Thus, as framed by the pleadings, the narrow issue in this case is whether the Treasury Form 1001 and the Netherlands Antilles Form VS-4, filed by Laatam with petitioner and by petitioner with the Court, are sufficient to qualify petitioner as exempted from withholding tax on the interest payment which it made to Laatam in 1980, under the terms of the Convention and the Protocol, thus supporting a decision in favor of petitioners. The cross-motions for summary judgment narrow the issue even further to the question of *when* such documents must be provided to petitioner.[4] Both parties appear to accept the authenticity of the documents, and that they would normally be sufficient to relieve petitioner of the withholding requirement. Petitioner, however, contends that these documents, even though executed in October 1984, are specifically applicable to a 3-year period including the year in issue, and are therefore sufficient under the Treaty and the Protocol, even though not filed until after the end of the year 1980 and after the filing of its Form 1042 and 1042S returns.

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[3] The parties' reliance upon the same documents indicates that there is no dispute between them as to authenticity.

Respondent, on the other hand, contends that the two Forms 1001 and VS-4 are not valid to grant petitioner exemption from the withholding requirement for the year 1980, because they were not issued nor filed with petitioner until 1984.

We conclude that there are no material facts in dispute and that the case may be decided as a matter of law, unde Rule 121. We further conclude that the extremely narrow issue presented here should be decided in favor of petitioner.

The controlling law on the subject is found in section 1441 and 1442, as modified by the Convention and Protoco between the United States and the Netherlands, the rele vant portions of which are quoted above herein. Said statutes, Convention, and Protocol are silent as to the type of documentation or proof, and the timing thereof, which must be supplied to or by a taxpayer such as thi petitioner, in order to secure the benefits of exemption from withholding with regard to the payment of interest to Netherlands Antilles corporation. Respondent's regulation section 1.1441-6(c), which we have quoted above, in relevant part, does require the execution and filing with *petitioner* o Form 1001. We give every benefit of the doubt to respon dent (as we should in testing the adequacy of petitioner's motion for summary judgment), and assume for presen purposes that the above regulation is a valid interpretive regulation, issued under the authority of section 7805, the Convention, and the Protocol,[5] and that it does not improp erly add additional requirements beyond the law, or limit rights which the law provides.[6] It nevertheless appears that respondent requires only that the foreign payee (Laatam in this case) furnish a Form 1001 to petitioner as withholding agent, without specifying the time when this should be done. Instead, the regulation provides only "Each such form filed with any withholding agent shall be filed as soon as practicable." We find this a very vague requirement, and can only infer that respondent was aware that in matters of this sort, involving foreign entities, there might be substantial time delays involved, for any one of a variety of reasons.

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[4] Respondent's regulation, sec. 1.1441-6, quoted in part above herein, does not require tha either such document be filed with respondent.

[5] See note 8 *infra*.

So far as the furnishing of the Netherlands Antilles Form VS-4 is concerned, respondent's regulations are silent. In his cross-motion for summary judgment, however, respondent urges that *both* the Treasury Form 1001 and the Netherlands Antilles Form VS-4 must be filed with petitioner as withholding agent *prior to the time the interest in question is paid.* In support of this proposition, respondent relies upon Rev. Proc. 79-40, 1979-2 C.B. 504, which indeed purports to impose such requirements. Such revenue procedures, however, like revenue rulings, do not have the force of law and are merely statements of respondent's litigating and administrative position. *Dixon v. United States,* 381 U.S. 68 (1965); *Stubbs, Overbeck & Associates v. United States,* 445 F.2d 1142, 1146-1147 (5th Cir. 1971); *Stemkowski v. Commissioner,* 76 T.C. 252, 295 (1981), affd. in part and revd. in part 690 F.2d 40 (2d Cir. 1982); *Rosenberg v. Commissioner,* 450 F.2d 529, 532 (10th Cir. 1971), affg. a Memorandum Opinion of this Court; *Collins v. Commissioner,* 61 T.C. 693, 701 (1974). We find nothing in the statute, the Convention, the Protocol, or respondent's regulations which imposes such requirements, either specifically or under any reasonable exegesis of those provisions. See and compare *Goodson-Todman Enterprises, Ltd. v.*

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[6] See and compare *Northern Natural Gas Co. v. O'Malley,* 277 F.2d 128, 134 (8th Cir. 1960); *United States v. Zions Savings & Loan Association,* 313 F.2d 331, 336 (10th Cir. 1963); *United States v. Marett,* 325 F.2d 28, 30 (5th Cir. 1963); *Coady v. Commissioner,* 33 T.C. 771, 779 (1960), affd. 289 F.2d 490 (6th Cir. 1961); *Estate of Boeshore v. Commissioner,* 78 T.C. 523, 527 (1982), appeal dismissed (7th Cir. 1983); *Harris v. Commissioner,* 32 T.C. 1216 (1959).

Commissioner, 784 F.2d 66 (2d Cir. 1986), modifying and affirming 84 T.C. 225 (1985).

It can be urged, no doubt, that the requirements as to documentation and the timing thereof, as mandated by respondent in Rev. Proc. 79-40, are not unduly burdensome upon taxpayers, and are reasonable provisions to assure the orderly and efficient administration of the laws and the protection of the revenues. In the context of the present issue before the Court, however, they go beyond this and have the effect of extending the law, and limiting the substantive rights of taxpayers, beyond that which the treaty provisions and respondent's regulations require. This is not permissible.[7] If respondent finds his existing regulation inadequate to carry out the administration of the Convention and the Protocol, he may amend the regulation in a manner not inconsistent with the rights granted under the covenants between the two nations.[8] He may not do so by administrative fiat, nor should he expect this Court to do it for him.

As we have said above, the cross-motions for summary judgment of the parties make it clear that they are in agreement that the two forms here in question are authentic and, in and of themselves, would be sufficient to confer the necessary exemption from withholding upon petitioner. The only dispute here is the matter of timing. On this narrow point, we hold that petitioner's receipt of these documents herein, even though accomplished after the year 1980, was sufficient under the statute, the Convention, the Protocol and respondent's regulation.

Petitioner's motion for summary judgment will accordingly be granted;[9] respondent's cross-motion for summary judgment will be denied; respondent's motion to strike petitioner's motion for summary judgment will be denied

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[7] See cases at note 6 *supra.*

[8] Art. XXVI(1) of the Convention provides:

"The authorities of each of the Contracting States, in accordance with the practices of that State, may prescribe regulations necessary to carry out the provisions of the present Convention." [T.I.A.S. 1855, 62 Stat. 1767.]

[9] Our holding on the principal issue automatically resolves in petitioner's favor the subsidiary issues involving additions to tax under secs. 6653(a) and 6656.

and respondent's motions to enforce discovery, filed herein on July 5, 1985, will be denied as moot.

Decision will be entered for the petitioner.

ROBERT W. CHAMBERS, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 10188-83, 10189-83, 10190-83, 10191-83.

Filed July 28, 1986.

The majority of CEI's voting and nonvoting common stock was held by three trusts, the Atlanta Trust I, the Atlanta Trust II, and the Dayton Trust. In December 1975, petitioner Anne Cox Chambers held a percentage interest in the life estate of the Atlanta Trust I of which petitioner Barbara Cox Anthony was the trustee, and petitioner Barbara Cox Anthony held a percentage interest in the life estate of the Atlanta Trust II of which petitioner Anne Cox Chambers was the trustee. Both petitioners held a percentage interest in the life estate of the Dayton Trust and were two of the three co-trustees of that trust. In December 1975, both petitioners also set up separate trusts for their children and transferred to these trusts undivided interests in their respective life estates in the Atlanta Trust I and the Atlanta Trust II. Such interests entitled these trusts to the income from a specified percentage interest in the nonvoting common stock of CEI held by the Atlanta Trust I or the Atlanta Trust II. *Held*, the transfers made in December 1975 by petitioners Anne Cox Chambers and Barbara Cox Anthony were completed as of the calendar year ended Dec. 31, 1975, for Federal gift tax purposes. *United States v. Byrum*, 408 U.S. 125 (1972), followed.

***Richard L. Braunstein*, *Bernard J. Long, Jr.*, *Albert H. Turkus*, *Joyce T. Gwadz*, and *Stuart A. Sheldon*, for the petitioners.**

***Sara M. Coe*, for the respondent.**

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[1] **Cases of the following petitioners are consolidated herewith: Garner Anthony, docket No. 10189-83; Barbara Cox Anthony, docket No. 10190-83; and Anne Cox Chambers, docket No. 10191-83.**

OPINION

STERRETT, *Chief Judge*: These consolidated cases ar before the Court on petitioners' motion for summar judgment filed pursuant to Rule 121, Tax Court Rules o Practice and Procedure.

In his statutory notices of deficiency dated February 3 1983, respondent determined deficiencies in petitioners Federal gift taxes as follows:

Docket No.	*Petitioner*	*Calendar year ended Dec. 31—*	*Deficiency*
10188-83	Robert W. Chambers	1976	$25,247.33
10189-83	Garner Anthony	1976	11,130.34
10190-83	Barbara Cox Anthony	1976	10,319.96
		1977	82.25
		1978	27,931.65
		1979	28,719.90
10191-83	Anne Cox Chambers	1976	25,247.33
		1977	46,243.10
		1978	77,795.65
		1979	82,754.09

The sole issue to be decided in determining whethe petitioners are entitled to prevail on their motion is whethe certain transfers made on December 12, 1975, by petitioner Anne Cox Chambers and Barbara Cox Anthony to variou trusts were completed as of that date for Federal gift ta purposes.[2]

Petitioners Robert W. Chambers and Anne Cox Chamber resided in Atlanta, Georgia, and petitioners Garne Anthony and Barbara Cox Anthony resided in Honolul Hawaii, at the time their petitions were filed in this cas During the calendar years in issue, petitioners Robert W Chambers and Anne Cox Chambers filed their Federal gi tax returns with the Internal Revenue Service in Atlant Georgia, and petitioners Garner Anthony and Barbara Co Anthony filed their Federal gift tax returns with th Internal Revenue Service in Fresno, California.

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[2] The deficiencies determined by respondent against Robert W. Chambers and Garn Anthony result solely from the fact that each consented to the attribution to him for Feder gift tax purposes of one-half of any and all gifts made by his spouse during the 1976 calend year.

Cox Enterprises, Inc. (hereinafter CEI), is a Delaware corporation that was incorporated on December 13, 1968. CEI's original capitalization consisted of 500,000 shares of voting common stock with a par value of $1 per share. As of December 12, 1975, CEI had issued and outstanding 402,319 shares of voting common stock and the majority of these shares was held by the following three trusts:[3]

Shareholder	*Number of shares*	*Percentage*
Atlanta Trust I	105,946	26.33
Atlanta Trust II	105,946	26.33
Dayton Trust	155,957	38.76
		91.42

The remaining 8.58 percent of voting common stock was held by numerous other unrelated shareholders.

As of December 12, 1975, petitioner Anne Cox Chambers was the owner of an 87.6628-percent interest in the life estate of the Atlanta Trust I, petitioner Barbara Cox Anthony was the owner of a 73.3043-percent interest in the life estate of the Atlanta Trust II, and they each owned a 48.1203-percent interest in the life estate of the Dayton Trust.[4] As life estate beneficiaries, petitioners were entitled to the dividends and distributions with respect to the stock, which included the CEI stock, that made up the corpus of the respective trusts.

As of December 12, 1975, petitioner Barbara Cox Anthony was the trustee of the Atlanta Trust I, petitioner Anne Cox Chambers was the trustee of the Atlanta Trust II, and both such petitioners as well as Robert W. Sherman, an unrelated party, were the co-trustees of the Dayton Trust. As the trustee of the Atlanta Trust I, petitioner Barbara Cox Anthony had the power to vote the CEI stock held by that trust and, as the trustee of the Atlanta Trust II, petitioner Anne Cox Chambers had the power to vote the CEI stock held by that trust. Each such petitioner, as one of three co-trustees of the Dayton Trust, had the power to participate in the voting of the CEI stock held by that trust.

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[3] The settlor of all three trusts was James M. Cox, who was the father of petitioners Anne Cox Chambers and Barbara Cox Anthony. While the settlor did not name the trusts, we so designated them for purposes of clarity.

[4] Daniel J. Mahoney, Jr., and J. Michael Mahoney, who are unrelated to petitioners, owned the remaining 3.759-percent interest in the life estate of the Dayton Trust. With respect to the Atlanta Trust I and the Atlanta Trust II, the record does not disclose who owned the remaining percentage interests in the life estates.

On December 12, 1975, two events occurred. First, the board of directors of CEI, of which petitioners comprised four of the seven members, and the stockholders of CEI approved a change in the capital structure of CEI. CEI's certificate of incorporation was amended to increase the capital stock of the corporation to 3 million shares of $1 par value common stock, which was divided into 2,900,000 shares of voting common stock and 100,000 shares of nonvoting common stock. These shares of voting and nonvoting common stock were distributed to CEI's shareholders on a pro rata basis in exchange for the previously issued voting common stock. The shares held by the three trusts after the distribution were as follows:[5]

	Voting shares of common stock		*Nonvoting shares of common stock*	
Shareholder	*Number*	*Percentage*	*Number*	*Percentage*
Atlanta Trust I	635,676	26.33	21,189	26.33
Atlanta Trust II	635,676	26.33	21,189	26.33
Dayton Trust	935,742	38.76	31,191	38.76

Second, petitioners Barbara Cox Anthony and Anne Cox Chambers established five trusts for the benefit of their respective children, a separate trust being established for each child. The term of each trust was 10 years and 1 month, beginning December 12, 1975, except that if the grantor or the beneficiary of a trust died before the end of the term, the trust would then terminate. Each such petitioner, as grantor, named herself as trustee with respect to the trusts benefiting her children. On December 12, 1975, petitioners Barbara Cox Anthony and Anne Cox Chambers also transferred to the respective trusts (hereinafter Clifford Trusts) undivided interests in their respective life estates under the Atlanta Trust I and the Atlanta Trust II.[6] Such interests entitled the respective Clifford Trusts to the dividends, distributions, and income from a specified percentage interest in the nonvoting common stock of CEI owned by the Atlanta Trust I or the Atlanta Trust II.

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[5] The record does not indicate whether any shares of stock were subsequently transferred by any of CEI's shareholders and we proceed on the assumption that no such transfers occurred during the calendar years in issue.

[6] Petitioner Anne Cox Chambers transferred a total of 70.11 percent of her life estate interest in the nonvoting common stock and petitioner Barbara Cox Anthony transferred a total of 35.05 percent of her life estate interest in the nonvoting common stock.

For the years 1976 through 1979, the following table sets forth the dividends that were declared, and subsequently paid, with respect to the voting and nonvoting common stock of CEI:

Date dividend declared[7]	*Voting common stock dividend*	*Nonvoting common stock dividend*
12/14/76	$1,013,844	$1,407,998
12/08/77	1,013,844	1,407,998
12/14/78	1,013,844	1,407,998
12/12/79	1,062,122	1,480,409

For the years 1976 through 1979, two independent appraisal firms provided appraisals with respect to the value of the CEI stock. The following table sets forth the value per share of the nonvoting common stock of CEI and the effective yield of such stock on the basis of the dividends declared during the calendar year in which the appraisals were made:

Date of appraisals	*Value per share of CEI nonvoting common stock based on average appraisals*[8]	*Yield*
12/31/76	$166.47	10.3
12/31/77	198.84	8.6
12/31/78	236.28	7.1
12/31/79	274.79	6.4

On or around March 15, 1976, Federal gift tax returns were filed reporting the December 12, 1975, transfers to the Clifford Trusts, and substantial gift taxes were paid. In his respective statutory notices of deficiency, respondent determined that petitioners' assignments of interests in the Atlanta Trust I and the Atlanta Trust II to the respective Clifford Trusts on December 12, 1975, did not constitute completed transfers. Respondent's position is that such transfers were completed when the dividends were declared on CEI's nonvoting common stock in December 1976, 1977, 1978, and 1979, and that Federal gift taxes are due on those transfers.

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[7] The record does not indicate the respective dividend's date of record, and we proceed on the assumption that the various dates of record occurred during the same calendar year in which the respective date of the dividend declaration occurred.

[8] Respondent did not challenge the appraisal values.

Under section 2501,[9] a tax is imposed on the transfer by an individual of property by gift. Section 2511 provides that the tax applies to direct or indirect transfers of all tangible and intangible property, whether in trust or otherwise. While the Internal Revenue Code does not define when a transfer becomes complete for gift tax purposes, section 25.2511-2(b), Gift Tax Regs., does elaborate on its meaning and provides in part as follows:

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. * * *

Petitioners, as the parties moving for summary judgment, have the burden of proving that no genuine issue exists with respect to any material fact and that they are entitled to judgment as a matter of law. *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157 (1970); *Gulfstream Land & Development Corp. v. Commissioner*, 71 T.C. 587, 596 (1979). Petitioners also have the burden of proof with respect to the deficiency determinations made in respondent's statutory notices. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

Respondent takes the position that the transfers were not completed in 1975 because petitioners, each or together, had the power to exercise voting control over CEI and that this control constituted a "reserve power" of "dominion and control" over the transferred interests in the CEI nonvoting common stock. Petitioners maintain that, notwithstanding respondent's argument, the December 12, 1975, transfers to the Clifford Trusts were completed gifts as a matter of law and they rely primarily on *United States v. Byrum*, 408 U.S. 125 (1972), an estate tax case involving section 2036, as support for their contention.

This is a razor's-edge case.

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[9] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the calendar years in issue.

We note at the outset that it is well established that the estate and gift taxes are to be read in pari materia and are to be construed together. *Estate of Sanford v. Commissioner*, 308 U.S. 39, 44 (1939); *Merrill v. Fahs*, 324 U.S. 308, 311-313 (1945); *Carson v. Commissioner*, 71 T.C. 252, 260 (1978), affd. 641 F.2d 864 (10th Cir. 1981). Specifically, in *Estate of Sanford v. Commissioner*, the Supreme Court stated at page 44:

> There is nothing in the language of the [gift tax] statute, and our attention has not been directed to anything in its legislative history to suggest * * * that *the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death.* The gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together. [Emphasis added.]

With that precept in mind, we proceed to examine the Supreme Court's decision in *United States v. Byrum, supra.*

In *Byrum*, the decedent transferred stock in three unlisted corporations, in which he was the majority stockholder, to an irrevocable trust for the benefit of his children. He retained in his individual capacity the right to vote the transferred stock, veto any transfer by the trustee, and appoint another corporate trustee as successor. The retained right to vote the transferred stock, together with the vote of the stock that the decedent owned at the time of his death, gave him a majority vote in each of the corporations.

Following the decedent's death, the Commissioner determined that the transferred stock was includable in his gross estate under either section 2036(a)(2) or (a)(1).[10] In specific, the Commissioner asserted that the rights the decedent retained with respect to the transferred stock, particularly the right to vote the transferred stock, were such that the decedent retained control over corporate dividend policy through his right to select the board of directors and therefore could regulate the flow of income to the trust. Thus, the Commissioner maintained that he had the power to shift or defer the beneficial enjoyment of the trust income between the present beneficiaries and remainderman and that this power amounted to the right to designate the persons who shall enjoy the income from the transferred property. In addition, the Commissioner argued that, by reason of his retained control over the corporation, the decedent had the right to continue to benefit economically from the transferred shares during his lifetime.

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[10] Sec. 2036(a) provided for the inclusion in a decedent's gross estate of all property which the decedent had transferred inter vivos if the decedent retained for his lifetime "(1) the possession or enjoyment of, or the right to the income from, the property" transferred, or "(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

The Supreme Court rejected the Commissioner's contentions and found that the rights the decedent reserved with respect to the transferred stock did not constitute retained enjoyment thereof or the right to designate the person or persons who enjoy the income therefrom. In support of its conclusion, the Court repeatedly emphasized the fiduciary duties of a majority shareholder and of the directors of a corporation. The Court stated that a majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests, and that the directors of a corporation have the fiduciary duty not to play favorites among the shareholders but rather must promote the interests of the corporation as a whole. The Court also stated that the business and economic vicissitudes of corporate existence and other diverse factors, such as the corporation's capital needs, the possibility of shareholder derivative suits to compel the payment of dividends, and the accumulated earnings tax of section 531, have a significant impact on the determination of a corporation's dividend policy by its board of directors. The Court held that these duties and factors so qualified the retained rights of the decedent that they were insufficient to cause inclusion of the stock in the decedent's gross estate under section 2036(a).

Since section 2036(a) reflects a "legislative policy of subjecting to tax all property which has been the subject of an incomplete inter vivos transfer" (*United States v. O'Malley*, 383 U.S. 627, 631 (1966)), it follows from the Supreme Court's analysis in *Byrum* that the decedent in that case had made a completed inter vivos transfer of the stock into trust.[11] Petitioners maintain that, since the estate and gift taxes are to be read in pari materia, the *Byrum* case is dispositive of the instant case and that, as a matter of law, petitioners' right to vote the CEI stock did not render the December 12, 1975, transfers to the Clifford Trusts incomplete for gift tax purposes. We agree with petitioners.[12]

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[11] See also our discussion of *Estate of Sanford v. Commissioner*, 308 U.S. 39, 44 (1939), *supra*, p. 9.

Respondent maintains that *Byrum* is distinguishable from the instant case. He argues that the decedent in *Byrum* parted with a substantial interest in property, the stock, whereas in the instant case petitioners only parted with an interest in their respective life estates. It seems to us that respondent is suggesting that, in determining whether a completed transfer has occurred for gift tax purposes, there is a difference between transfers of an entire interest in property and transfers of a partial interest in property. We do not agree, nor do his own regulations. Section 25.2511-1(e), Gift Tax Regs., provides in relevant part as follows:

> If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. The tax is applicable, for example, * * * to the transfer of a life estate when the grantor retains the remainder interest * * *

Thus, it is clear that assignments of interests in life estates are transfers for gift tax purposes. See *Hrobon v. Commissioner*, 41 T.C. 476, 492-500 (1964)(life tenant's gift of, inter alia, the value of 40 percent of trust income); *Fuller v. Commissioner*, 37 T.C. 147, 152-155 (1961)(widow's renunciation of part of her life interest in estate).

Furthermore, it should be remembered that petitioners, in their individual capacities, had life estate interests in the Atlanta Trust I and the Atlanta Trust II that entitled them only to the income generated by the respective trusts. Thus, with respect to their transfers to the Clifford Trusts, they parted with their entire interests in the transferred property. No strings were attached to these transfers whereas in *Byrum* the decedent parted with the voting stock he transferred into trust but retained the right to vote such stock. This difference further strengthens petitioners' case.

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[12] We note that Congress, in response to *United States v. Byrum*, 408 U.S. 125 (1972), made admendments to section 2036. Since such amendments are effective for transfers after June 22, 1976, they are not applicable to the transfers which occurred on December 12, 1975. There also might be a question with respect to whether sec. 2036, as amended, would apply to facts similar to those in this case. S. Rept. 95-745, at 89, 91 (1978).

While petitioners did have the right to vote a certain percentage of the CEI stock, this right arose solely from the fact that they were trustees of the various trusts. As trustees, they were under a fiduciary obligation to the beneficiaries of the trusts. Thus, any influence petitioners might have had over the nonvoting stock interests transferred to the Clifford Trusts was no greater than those powers of trust administration and management that the gift tax allows to a donor-trustee. Section 25.2511-2(g), Gift Tax Regs., provides:

> If a donor transfers property to himself as trustee (or to himself and some other person, not possessing a substantial adverse interest, as trustees), and retains no beneficial interest in the trust property and *no power over it except fiduciary powers*, the exercise or nonexercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, *the donor has made a completed gift* and the entire value of the transferred property is subject to the gift tax. [Emphasis added.]

In addition, petitioners, as directors of CEI, had the fiduciary duty to promote the interests of the corporation as a whole. Because of this fiduciary duty, as well as the fiduciary duty as trustees, petitioners were subject to fiduciary constraints similar to the ones found dispositive in *Byrum*.

In opposing petitioners' motion, respondent relies solely on *Overton v. Commissioner*, 6 T.C. 304 (1946), affd. 162 F.2d 155 (2d Cir. 1947), for the proposition that the transfers were not completed in 1975. In *Overton*, two taxpayers restructured a corporation that they controlled and transferred newly issued, nonvoting common stock of the corporation to their wives. The value of the transferred stock was nominal as the liquidation value of the new nonvoting shares was set at $1 per share and the shares were subject to a shareholder agreement restricting their resale price to $1 per share. The taxpayers did not file gift tax returns with respect to the transferred nonvoting common stock on the basis that the restrictions on the liquidation value and resale price of the shares rendered the value of such shares to be only $1 per share. Despite the nominal value accorded to the nonvoting common stock by the taxpayers, the dividends received with respect to such stock were grossly disproportionate to the stock's value.

Respondent attacked the transaction on the ground that the amounts formally designated as dividends on the nonvoting common stock were in fact attributable to the voting common stock of the corporation. This Court agreed with respondent. Noting that the dividends received with respect to nonvoting common stock were grossly disproportionate to the stock's value, we held that the property that earned the large dividends received by the taxpayers' wives was, in reality, the voting common stock held by the taxpayers. In affirming the decision, the Second Circuit found that the taxpayers in actuality gave their wives nothing of value, or substantially nothing, and that, with respect to one of the taxpayers, he made gifts to his wife of the dividend income earned on his voting common stock.

Respondent's reliance on *Overton* is misplaced because, unlike the situation in *Overton*, petitioners actually transferred interests in their respective life estates to the respective Clifford Trusts. In fact, respondent implicitly concedes that fact with his contention that gifts are made when the dividends are declared; some interest must have been transferred with respect to which the dividends were declared. In addition, these interests had a substantial value as evidenced by the independent appraisals made with respect to the nonvoting common stock and the substantial gift taxes that were paid by petitioners with respect to their transfer. Respondent has not challenged the valuation as such. It also should be noted that the dividends received with respect to the nonvoting common stock were reasonable in relation to the stock's value, whereas in *Overton*, it was grossly disproportionate.[13] Furthermore, it should be mentioned that this Court, as well as the Second Circuit, in *Overton* was not faced with the question of whether voting control over a corporation, which is constrained by fiduciary duties, renders a transfer of nonvoting stock interests of that corporation an incomplete gift for gift tax purposes.[14] Finally, *Overton* was decided before *Byrum*, so we are not required to decide whether *Overton* was sub silentio overruled by *Byrum*.

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[13] We further note that respondent made no argument in this case with respect to the relative amount of dividends received on the voting and nonvoting common stock.

For the above-stated reasons, we grant petitioners' motion for summary judgment.

Appropriate orders and decisions will be entered.

JAMES EDWARD BENT, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 11963-80. Filed July 28, 1986.

After petitioner, a teacher at a public high school, criticized the school administration, the local school board decided not to rehire him. Petitioner sued the school board in a State court, alleging contract violations and numerous violations of 42 U.S.C. sec. 1983. In deciding only the liability issue, the State court concluded that petitioner's right to freedom of speech had been abridged, in violation of 42 U.S.C. sec. 1983; the State court rejected the contract claim and the other 42 U.S.C. sec. 1983 claims. Thereafter, the parties reached a settlement and petitioner received a $24,000 settlement payment, of which $8,000 was paid for legal fees. *Held*:

1. The settlement payment was made on the basis of the State court's decision that petitioner's First Amendment right to freedom of speech had been abridged, and that petitioner was entitled to redress under 42 U.S.C. sec. 1983. Determining the "intent of the payor" in this situation is unnecessary.

2. Damages received on account of a claim under 42 U.S.C. sec. 1983 are received on account of personal injuries and so are excludable from income. Sec. 104(a)(2), I.R.C. 1954; sec. 1.104-1(c), Income Tax Regs.

3. The amount paid for legal fees to pursue such a claim is not deductible. Sec. 265(1), I.R.C. 1954.

James Edward Bent, pro se.

Joellyn R. Cattell, for the respondent.

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[14] This Court has held that under similar circumstances, the transfer is a completed gift for purposes of the charitable contribution deduction pursuant to sec. 170. *Pullman v. Commissioner*, T.C. Memo. 1964-218.

CHABOT, *Judge*: Respondent determined a deficiency in Federal individual income tax against petitioner for 1977 in the amount of $5,402.38. After concessions by respondent, the issues for decision are as follows:

(1) Whether a $24,000 settlement payment to petitioner from Marshallton-McKean School District, in settlement of litigation, is excludable from gross income under section 104(a)(2);[1] and

(2) Whether petitioner is entitled to a deduction for the amount paid as legal fees, if the settlement payment is excludable.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner resided in Newark, Delaware.

Petitioner was hired by the Board of Education (hereinafter sometimes referred to as the board) of the Marshallton-McKean School District (hereinafter sometimes referred to as the district) as a secondary school teacher, beginning in September 1970. Petitioner taught in the area of Industrial Arts—Electronics Technology at McKean High School (hereinafter sometimes referred to as McKean). At this time, petitioner was 46 years old and, with the exception of a few months during the summer of 1970, he had never taught in public schools. Petitioner has a degree in biology and spent the majority of the 1950's and 1960's employed in the field of electronics, including overseas assignments. Although petitioner did not have an education degree, the board believed that, with his background and experience in the electronics industry, he was well-qualified to teach an electronics course at McKean. Petitioner's practical approach to the subject matter was consistent with the new teaching approach that was being experimented with at McKean.

For the first two school years, petitioner performed his duties to the apparent satisfaction of his superiors. In particular, petitioner was evaluated twice during each of these 2 school years; with the exception of certain comments about the lack of orderliness in his laboratory, his occasional inattention to detail and school procedures, and his tendency to use "rough" or "raw" language, petitioner's evaluations indicated satisfactory performance.

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[1] Unless indicated otherwise, all subtitle and section references are to subtitles and sections of the Internal Revenue Code of 1954 as in effect for the year in issue.

In addition to his duties as a high school teacher, petitioner was also active in the Marshallton-McKean Education Association (hereinafter sometimes referred to as "the association"), the collective bargaining representative for the teaching personnel in the district. In the 1972-73 school year, petitioner held the position of building representative; teacher complaints on various matters were channeled to the administration through him.

The approach to education at McKean was thought to be unsuccessful; beginning with the 1972-73 school year, two new administrators were hired at McKean.

On November 2, 1972, petitioner attended an open meeting of the board. Without the approval of the association, petitioner demanded the floor, and argued on a then-existing issue of whether the school custodians should be given the day off on election day. The association was dealing with this matter through other individuals; petitioner acted apparently outside his scope of authority as well as his area of concern. His conduct was distasteful to some members of the board and was not well received by the association. As a result, petitioner had misgivings about the security of his teaching position and he requested an evaluation of his progress as a teacher.

One of the new McKean administrators performed the evaluation on December 5, 1972. He noted that petitioner was "very direct and occasionally outspoken" and that while his sincerity was unquestionable, his method was subject to being misunderstood. The administrator concluded that petitioner would be recommended for reemployment the following year even though he would still have to undergo one final evaluation. Thereafter, in January 1973, petitioner attended an evening meeting of science teachers from several different schools; the other new McKean administrator also attended. Petitioner had admittedly been drinking before he attended this out-of-school meeting.

During the meeting, petitioner presented his views on how teaching should be accomplished. His remarks were directly critical of a computer education program instituted by the McKean administrator who attended this meeting. This administrator was personally offended by these remarks, as well as by other remarks which he considered unduly critical of the McKean administration.

On February 28, 1973, petitioner was given his final evaluation, this time by the administrator who had attended the science teachers meeting. This administrator stated that petitioner "displays unprofessional behavior by consistently downgrading the school, the staff, and the administration". This administrator concluded that petitioner should not be recommended for reemployment because "he does not exhibit the degree of professionalism expected of a professional educator."

When petitioner was informed of the contents of the evaluation, he made sarcastic remarks to a McKean administrator in the presence of other school personnel. Petitioner threatened legal action and set upon a course of late evening telephone calls to members of the board and to members of the association.

Subsequently, petitioner disclosed that he had secretly recorded telephone conversations with a McKean administrator and with the district's superintendent. On April 19, 1973, the board voted to terminate petitioner's employment and not to offer him a contract for the next school year. On May 3, 1973, the district's superintendent sent a letter to petitioner stating the reasons for the termination of petitioner's employment. The reasons given were those set forth in the February 28 evaluation and the fact that petitioner secretly recorded telephone calls.

Thereafter, petitioner asked for a hearing before the board, but this was rejected. His employment contract with the district expired on June 30, 1973. Petitioner never was granted tenure by the district. In August 1973, the board changed its position and decided to give petitioner a hearing. However, by this time, petitioner had accepted a teacher-training job at Temple University, beginning in September 1973, and his counsel was unavailable for a hearing. The board never held a hearing for petitioner.

In September 1973, petitioner sued the board, its members, and its secretary in the Court of Chancery of the State of Delaware in and for New Castle County (hereinafter sometimes referred to as "the Chancery Court"). The complaint set forth the following contentions:

> 9. The aforesaid actions of defendants have violated plaintiff's rights as follows:
>
> a. Defendants have breached the said collective bargaining agreement in refusing to process plaintiff's grievance, in refusing to rehire plaintiff without just cause in violation of Article IIID, and in refusing to make specific suggestions for improvement, and refusing to make any effort to help the plaintiff correct his weaknesses and strengthen his performance in violation of Articles XIE and XIF.
>
> b. The refusal to grant plaintiff a prompt hearing violated plaintiff's right to procedural due process, to which he is entitled under the Constitution of the United States and 42 U.S.C. §1983.
>
> c. The arbitrary refusal to rehire the plaintiff violated his rights to substantive due process and free speech, in violation of the Constitution of the United States and 42 U.S.C. §1983.
>
> d. The defendants' action imposed a stigma upon plaintiff which has foreclosed his opportunity to obtain other employment in education, in violation of the Constitution of the United States and 42 U.S.C. §1983.
>
> e. The action of defendants deprived the plaintiff of property, in that consistent with the practice of defendants, plaintiff had an objective expectancy of reemployment and a consequent right to a hearing before being non-renewed, pursuant to the Constitution of the United States and 42 U.S.C. §1983.
>
> 10. As a result of the foregoing actions of defendants, all of which were taken in bad faith, plaintiff has been deprived of his employment in the Marshallton-McKean School District for 1973-74 and has been otherwise damaged.

In his complaint, petitioner asked the Chancery Court to "reinstate him and order the * * * [board] to tender a contract of employment for the balance of the 1973-74 school year, and award him incidental damages, attorney's fees, interest, costs and such other relief as the Court deems appropriate."

After a trial on the issue of liability, a decision was rendered on December 11, 1975, in which the Chancery Court concluded—

> that the plaintiff, James E. Bent, is entitled to relief as a result of having been denied reemployment by the defendant Board of Education for reasons which, in part, abridged his First Amendment right to express

> his views as to the public employer and school administrators for whom he worked—regardless of his obvious lack of tact in so doing.
>
> Although he seeks both reinstatement as well as monetary damages, I am not prepared to conclude that reinstatement is automatically required by the above finding, and I am inclined to limit relief to monetary damages. Defendants reserved the right to be heard separately of the issue of the amount and form of recovery in the event that liability was established on their part.

In disposing of petitioner's other contentions, the Chancery Court determined that "it seems clear * * * that although plaintiff surely had an abstract concern in being rehired, he did not acquire a *property* interest sufficient to require the school authorities to give him a hearing when they declined to renew his contract of employment". (Emphasis in original.) In addition, the Chancery Court explained that "mere proof of his record of nonretention in one job * * * does not amount to the kind of foreclosure of opportunities which would constitute a deprivation of liberty. Also, since [petitioner] freely admits making the secret tape recordings, [there is] no denial of due process in failing to afford him a hearing to disprove that he did so."

The Chancery Court continued the case on the issue of money damages and both sides submitted briefs on this issue.

In his opening post-trial brief in the Chancery Court proceeding, petitioner stated as follows:

> The Court deferred decision on damages and the parties have conferred and agreed that for purposes of briefing the special damages of the plaintiff shall be viewed as the following:

Wage loss differential	$4,000 per year (12,000 to date)
Blue Cross	300 per year (900 to date)
Commuting differential	600 per year (1,800 to date)
Expense of seeking other employment	250
Replacement of other fringe benefits (annuity, group life policy, disability insurance, retirement benefits)	3,000
Physicians bills and medication	200
Attorneys' fees	12,000
Total to date	30,150

> In addition [petitioner] seeks an award of general damages for the deprivation of his constitutional rights and for the pain, suffering, humiliation, mental anguish and disruption of career plans engendered by the non-renewal for an unconstitutional reason. This is [petitioner's] opening brief in support of his claim for damages.

On January 24, 1977, after an extended period of negotiations, the case was settled and petitioner's complaint was dismissed with prejudice. In settlement of his lawsuit, petitioner accepted a check for $24,000 from INA Insurance Cos(hereinafter sometimes referred to as INA).[2] Petitioner executed a general release in consideration of the settlement payment. Neither petitioner's release nor INA's check allocated any part of the settlement payment.

Petitioner paid $8,000 of the settlement payment to the Delaware State Education Association (hereinafter sometimes referred to as the State association). The State asociation had provided petitioner with legal representation in connection with the termination of his employment by the district, and the $8,000 payment was made by petitioner on account of this legal representation.

George Eichelberger (hereinafter sometimes referred to as Eichelberger), assistant manager for the INA office in Wilmington, Delaware, dealt with petitioner's claim against the board. Eichelberger approved the settlement payment of $24,000 to petitioner. The "Notice of Close-Out", a document prepared by INA, regarding the settlement of petitioner's claim against the district, states that petitioner's claim has been settled for $24,000—"12,000 Re-instatement of wage loss" and "12,000 Plaintiff attorney fees - recoverable as a specific item in civil rts cases".

Petitioner did not report the $24,000 settlement payment as income on his 1977 Federal individual income tax return. Petitioner deducted the $8,000 in legal fees on his 1977 return. Respondent determined that the $24,000 amount is includable in income on petitioner's 1977 return and, that, if the settlement payment is excludable, then the $8,000 paid as legal fees is not deductible.

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[2] INA assigned an attorney to represent its policyholder, the District, in the Chancery Court proceedings.

The settlement payment was made on the basis of the Chancery Court's decision that petitioner's right to freedom of speech under the First Amendment to the United States Constitution had been abridged, in violation of 42 U.S.C. sec.

OPINION

Respondent contends that the $24,000 settlement payment is includable in gross income because it "represented compensation to [petitioner] for a wage differential for three years plus a negotiated attorney's fee." Respondent asserts also that petitioner is entitled to deduct legal fees only to the extent that the settlement payment is includable in gross income.[3] Petitioner maintains that the Chancery Court's decision that the district had abridged his First Amendment right to freedom of speech is a decision that this abridgement "constituted a tort, and, as such a personal injury" for section 104(a)(2) purposes. Thus, petitioner contends, the settlement payment is excludable from his gross income. Petitioner asserts further that the legal fees paid "reduce the amount paid to make him whole and as such, become a deductible item."

We agree with petitioner as to the excludability issue, and with respondent as to the deductibility issue.

I. *Exclusion of Settlement Payment*

Section 61(a)[4] states that, except as otherwise provided, gross income means "all income from whatever source derived". Section 104(a)(2)[5] provides otherwise, in that it excludes from gross income damages received on account of personal injuries or sickness. However, the Internal Revenue Code of 1954 does not explain what a taxpayer must show in order to prove that the damages were received "on account of personal injuries." *Seay v. Commissioner*, 58 T.C. 32, 36 (1972).

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[3] At trial, in her opening statement, respondent's counsel stated that respondent was considering moving to amend the answer to assert that all or part of petitioner's $8,000 legal fee deduction should be disallowed even if the Court were to hold (for respondent) that all of the $24,000 settlement payment is includable in petitioner's income. See sec. 6214(a). By the end of the trial, respondent's counsel decided not to offer such an amendment to answer.

[4] Sec. 61(a) provides, in relevant part, as follows:

SEC. 61. GROSS INCOME DEFINED.

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle [i.e., subtitle A, relating to income taxes], gross income means all income from whatever source derived, * * *

[5] Sec. 104(a) provides, in relevant part, as follows:

SEC. 104. COMPENSATION FOR INJURIES OR SICKNESS.

(a) IN GENERAL.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

Section 1.104-1(c), Income Tax Regs., provides that "The term 'damages received (whether by suit or agreement)' means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution"; thus, it is not necessary that the damages be on account of physical trauma. *Church v. Commissioner*, 80 T.C. 1104, 1106 (1983). The essential element of an exclusion under section 104(a)(2) is that the damages must derive from some sort of tort (or tort-type) claim against the payor. *Glynn v. Commissioner*, 76 T.C. 116, 119 (1981), affd. without published opinion 676 F.2d 682 (1st Cir.1982); sec. 1.104-1(c), Income Tax Regs.

Section 104(a)(2) encompasses situations where the damages received are "by suit or agreement". In the context of a settlement agreement, determining the exclusion from gross income depends on the *nature* of the claim which was the actual basis for settlement, not the *validity* of the claim (*Seay v. Commissioner*, 58 T.C. at 37), the proper inquiry being in lieu of what were damages awarded. *Church v. Commissioner*, 80 T.C. at 1107; *Yates Industries, Inc. v. Commissioner*, 58 T.C. 961, 972 (1972), affd. without published opinion 480 F.2d 920 (3d Cir. 1973). If the settlement agreement lacks express language stating that the payment was (or was not) made on account of personal injury, then the most important fact in determining how section 104(a)(2) is to be applied is "the intent of the payor" as to the purpose in making the payment. *Knuckles v. Commissioner*, 349 F.2d 610 (10th Cir. 1965), affg. a Memorandum Opinion of this Court;[6] *Fono v. Commissioner*, 79 T.C. 680,

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* * * * * * *

(2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness;

[The subsequent amendment of this provision by sec. 101(a) of Pub. L. 97-473, 96 Stat. 2605, does not apply to the instant case]

[6] T.C. Memo. 1964-33.

694 (1982), affd. without published opinion 749 F.2d 37 (9th Cir. 1984); *Glynn v. Commissioner*, 76 T.C. at 120.

In the context of a suit, if the trier of fact (jury or judge) does not indicate the basis on which the award was arrived, then to ascertain the nature of the damages it is necessary to examine the allegations contained in the taxpayer's complaints, the evidence presented, and the arguments made in the State court proceeding. *Church v. Commissioner*, 80 T.C. at 1107.

The first matter that we must determine is what the settlement settled. In his suit, petitioner complained that the board had violated his rights under the collective bargaining agreement and had violated several of his rights under the United States Constitution. As to the claimed violations of his rights under the United States Constitution, petitioner was suing for redress under 42 U.S.C. sec. 1983[7] (hereinafter sometimes referred to as sec. 1983).

The Chancery Court decision rejected all of petitioner's claims except the one that the board had "abridged his First Amendment[8] right to express his views as to the public employer and school administrators for whom he worked". This claim was one of those for which petitioner had sued for redress under sec. 1983. The Chancery Court rejected petitioner's contention that he was entitled to reinstatement but ruled that monetary damages was the appropriate redress and continued the case to determine the amount and form of such a redress. Both sides filed briefs on monetary damages in the Chancery Court.

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[7] Sec. 1983. Civil action for deprivation of rights

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress. * * *

[The subsequent amendments of this section by Pub. L. 96-170, 93 Stat. 1284, do not affect the instant case.]

[8] The First Amendment to the United States Constitution provides as follows:

> Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.

The First Amendment right of freedom of speech is "protected by the Fourteenth Amendment from invasion by state action." *Lovell v. Griffin*, 303 U.S. 444, 450 (1938), and cases there cited.

It was in this setting that petitioner and the board settled the Chancery Court suit. Neither the general release that petitioner signed nor INA's settlement check allocated any part of the settlement payment. We conclude, and we have found, that the settlement payment was made on the basis of the Chancery Court's decision that petitioner's First Amendment right to freedom of speech had been abridged in violation of sec. 1983. In this light, we view the instant case as being equivalent to a situation where the settlement agreement provided the basis upon which the settlement payment was made. Accordingly in this situation, we need not engage in an analysis of the "intent of the payor" to establish the nature of the payment. See *Knuckles v. Commissioner, supra; Fono v. Commissioner, supra;* see also *Lyeth v. Hoey*, 305 U.S. 188, 195-197 (1938). However, this does not end our inquiry, for we must now ascertain the nature of a sec.1983 claim, in order to determine the tax consequences of the settlement payment. *Seay v. Commissioner, supra.*

In *Mitchum v. Foster*, 407 U.S. 225, 238-239 (1972), the Supreme Court provided the following historical overview of sec. 1983:

> Section 1983 was originally § 1 of the Civil Rights Act of 1871. 17 Stat. 13. It was "modeled" on § 2 of the Civil Rights Act of 1866, 14 Stat. 27, and was enacted for the express purpose of "enforc[ing] the Provisions of the Fourteenth Amendment." 17 Stat. 13. The predecessor of § 1983 was thus an important part of the basic alteration in our federal system wrought in the Reconstruction era through federal legislation and constitutional amendment. As a result of the new structure of law that emerged in the post-Civil War era—and especially of the Fourteenth Amendment, which was its centerpiece—the role of the Federal Government as a guarantor of basic federal rights against state power was clearly established. *Monroe v. Pape*, 365 U.S. 167; *McNeese v. Board of Education*, 373 U.S. 668; *Shelley v. Kraemer*, 334 U.S. 1; *Zwickler v. Koota*, 389 U.S. 241, 245-249; H. Flack, The Adoption of the Fourteenth Amendment (1908); J. tenBroek, The Anti-Slavery Origins of the Fourteenth Amendment (1951). Section 1983 opened the federal courts to private citizens, offering a uniquely federal remedy against incursions under the claimed authority of state law upon rights secured by the Constitution and laws of the Nation. [Fn. refs. omitted.]

With the enactment of sec. 1983, the Congress "create[d] a federal cause of action 'unknown at common law', [for] the deprivation of any rights, privileges, or immunities secured by the Constitution and laws [of the United States]", *Almond v. Kent*, 459 F.2d 200, 204 (4th Cir. 1972).

The Supreme Court stated in *Carey v. Piphus*, 435 U.S. 247, 253 (1978), that the legislative history of sec. 1983[9] "demonstrates that it was intended to '[create] a species of tort liability' in favor of persons who are deprived of 'rights, privileges, or immunities secured' to them by the Constitution. *Imbler v. Pachtman*, 424 U.S. 409, 417 (1976)." The right of recovery on the basis of a sec. 1983 claim depends on Federal considerations. *Almond v. Kent*, 459 F.2d at 204.

In *Wilson v. Garcia*, 471 U.S. 261 (1985), the Supreme Court was faced with determining the appropriate New Mexico statute of limitations to be applied to a sec. 1983 claim. Garcia brought an action under sec. 1983 against a State police officer and the chief of the State police seeking damages for deprivation of Garcia's constitutional rights allegedly caused by an unlawful arrest and brutal beating by the officer. First, the Supreme Court determined that Federal rather than State law governs the characterization of a sec. 1983 claim for statute of limitations purposes. 471 U.S. at 268-270. Second, the Supreme Court concluded that all sec. 1983 claims should be characterized in the same way. 471 U.S. at 270-275. Third, the Supreme Court held that all sec. 1983 actions are best characterized as involving claims for personal injuries. 471 U.S. at 276-279. Thus, the State's statute of limitations for personal injury actions applies to all sec. 1983 claims. See *Mazzanti v. Merek & Co.*, 770 F.2d 34 (3d Cir. 1985); *Fitzgerald v. Larson*, 769 F.2d 160 (3d Cir. 1985); *Smith v. City of Pittsburgh*, 764 F.2d 188 (3d Cir. 1985); *Knoll v. Springfield Tp. School Dist.*, 763 F.2d 584 (3d Cir. 1985). In reaching this conclusion, the Supreme Court determined that while a sec. 1983 claim can be analogized to more than one of the common law forms of action (471 U.S. at 272-274), "Congress unquestionably would have considered the remedies established in the Civil Rights Act to be more analogous to tort claims for personal injury than, for example, to claims for damages to property or breach of contract."

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[9] The legislative history of sec. 1983 is detailed in *Monroe v. Pape*, 365 U.S. 167, 172-183 (1961); *id.* at 225-234 (Frankfurter, J., dissenting in part); *Mitchum v. Foster*, 407 U.S. 225, 238-242 (1972).

471 U.S. at 277. The Supreme Court explained as follows (471 U.S. at 277-278):

> The unifying theme of the Civil Rights Act of 1871 is reflected in the language of the Fourteenth Amendment that unequivocally recognizes the equal status of every "*person*" subject to the jurisdiction of any of the several States. The Constitution's command is that all "*persons*" shall be accorded the full privileges of citizenship; no *person* shall be deprived of life, liberty, or property without due process of law or be denied the equal protection of the laws. A violation of that command is an injury to the individual rights of the person.
>
> Relying on the language of the statute, the Court of Appeals for the Fourth Circuit has succinctly explained why this analogy is persuasive: "In essence, § 1983 creates a cause of action where there has been injury, under color of state law, to the person or to the constitutional or federal statutory rights which emanate from or are guaranteed to the person. In the broad sense, every cause of action under § 1983 which is well-founded results from 'personal injuries.'" *Almond v. Kent*, 459 F.2d 200, 204 (CA4 1972).
>
> [Emphasis in original; fn. ref. omitted.]

The Supreme Court concluded that "Had the 42d Congress expressly focused on the issue decided today, we believe it would have characterized sec. 1983 as conferring a general remedy for injuries to personal rights." 471 U.S. at 278.

The situation in the instant case is analogous to *Wilson v. Garcia* because in both cases the determinative inquiry involves the characterization of the nature of a sec. 1983 claim. Although the bottom-line issue (statute of limitations versus application of sec. 104(a)(2)) is different, the Supreme Court's analysis provides the answer to our inquiry.

Section 104(a)(2) excludes from gross income "any damages received * * * on account of personal injuries". Section 1.104-1(c), Income Tax Regs., states that damages are excludable if received on account of a legal suit or action involving tort or tort-type rights. From this Treasury Regulation, the validity of which is not in question, it is apparent that excludable damages need not be restricted to those suits or actions involving a tort right—recognized either at common law or under State law. Instead, section 104(a)(2) extends also to those suits or actions which involve a legal right that is more analogous to a tort-type right than to any other legal category of rights. The Supreme

Court has declared that sec. 1983 "was intended to '[create] a species of tort liability'" (*Carey v. Piphus*, 435 U.S. at 253), and has held "that §1983 claims are best characterized as personal injury actions" (*Wilson v. Garcia*, 471 U.S. at 280.). We conclude that, under both the language of the statute and the interpretation of it that is provided by the regulation, gross income does not include damages received under a sec. 1983 claim based on violation of petitioner's First Amendment right to free speech.

On brief, respondent contends that—

> Here the record indicates that the primary reasons for the dispute between the petitioner and the Board involved dissatisfaction by the Board with the petitioner's job performance. In other words, the basis of that controversy was essentially contractual in nature.

We do not so read the record in the instant case. Rather, we agree with the Chancery Court's focus on petitioner's extracurricular public statements. The board had successfully fought off any liability for any part of the original dispute that "was essentially contractual in nature" and nothing in the record shows an intent by the board to pay petitioner to settle issues that the board had already won.[10]

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[10] On cross-examination, Eichelberger testified as follows:

[BENT:] Now, what was your basic motive—I'll go back to this point one time—what was your basic motive in settling the case, regardless of the amount involved? What were you trying to do for the school board?

[EICHELBERGER:] I don't understand what you mean by motive; what my only motive would be is to do my job. And if it looks like we investigate a case and it looks like it's one to settle, we settle it.

Q. Why did you feel that this case had to be settled?

A. Well, I think you're aware that it was tried once; and Chancellor Brown found partially in your favor.

Q. How did he find in my favor?

* * * * * * *

[A.] Chancellor Brown ruled that you were not to be reinstated, but that he felt that you were entitled to some monetary restitution.

* * * * * * *

Q. For what purpose?

A. He thought—well, I—well, he thought that there had been a wrong.

Q. And what was that wrong?

A. Well, I think you'd have to ask Chancellor Brown from that point. We didn't particularly agree with that; I think our attorney filed an appeal on that decision; and the appeal, I think was still pending when we settled.

Q. But you did settle.

A. I think you're aware of that, yeah.

Q. Okay.

samsamAfter Chancellor Brown's decison.

A. Yes we did, yeah.

Respondent has introduced evidence concerning the negotiations between petitioner and the payor, INA. Eichelberger testified as to his recollection of the events. He explained to the Court the procedures of INA in suits involving its policyholders, with particular emphasis on the documents used by INA, including some of the documents contained in the file it maintained on petitioner's claim against the board. Furthermore, on brief, respondent stressed Eichelberger's testimony regarding the $24,000 settlement payment, which Eichelberger believed was for $12,000 in lieu of lost wages and $12,000 for petitioner's attorney fees.

It is abundantly clear that "lost earnings" is a proper element of compensatory damages that may be awarded under sec. 1983 in order to redress the party who has been injured by a deprivation of First Amendment rights under color of State law. See *Memphis Community School Dist. v. Stachura*, 477 U.S. ____ (1986) (a jury awarded damages to a secondary school teacher because the teacher's employer, a public school board, suspended the teacher from employment, in violation of his First Amendment rights). In the instant case, respondent directs us to evidence that INA considered petitioner's lost wages in settling petitioner's suit against the board, and would have us regard such evidence as pointing to a conclusion that the settlement was of an employment contract claim. However, consideration of a taxpayer's lost wages is appropriate in disposing of a sec. 1983 claim for redress of injuries resulting from violations of the First Amendment, as well as in disposing of an employment contract claim. It follows that this evidence is consistent with petitioner's case as well as with respondent's case.

Q. And though your attorney may have filed an appeal, if you settled you must have thought that that appeal did not have too much merit.

A. I wouldn't say that; we already had lost once, which is an indication that we had—the school district had a weakness in their defense.

Q. Okay; well, what was that weakness? You had to have a motive for paying money. You don't pay $24,000 without—

A. Well, I've said it before; Chancellor Brown gave an adverse decision.

Q. But what was the decision based on?

A. Well, I'll say it again; he thought—apparently he thought that there had been a wrong. You had been wronged; your civil rights had apparently been violated. And he said to make it—he felt that there should be a monetary reimbursement done to you—done—

Q. Then you basically paid the money to right that wrong.

A. Yeah.

MR. BENT: No more questions, Your Honor.

After examining the record, including the decision of the Chancery Court, we conclude that the element of lost wages was not an independent basis for recovery but only an evidentiary factor in determining the amount by which petitioner was damaged. See *Memphis Community School Dist. v. Stachura, supra*; *State Fish Corp. v. Commissioner*, 48 T.C. 465, 476-477 (1967); see also *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113-114 (1st Cir. 1944), affg. 1 T.C. 952 (1943).

We hold for petitioner on this issue.

II. *Deduction of Legal Fee*

Section 265[11] precludes a deduction for the amount paid for legal fees if it is allocable to a class of income exempt from taxation. Thus, with the $24,000 settlement payment excludable from gross income, the $8,000 amount paid for legal fees is not deductible. *Church v. Commissioner*, 80 T.C. at 1110-1111; see also *Deason v. Commissioner*, 41 T.C. 465, 467-468 (1964).

We hold for respondent on this issue.

Decision will be entered under Rule 155.

THE "MISS ELIZABETH" D. LECKIE SCHOLARSHIP FUND, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5028-84X. Filed July 30, 1986.

P, a "sec. 509(a) private foundation," seeks a declaratory judgment from R's final ruling denying it "operating foundation" status, as defined in sec. 4942(j)(3), I.R.C. 1954. P is already a charitable trust exempt from Federal income

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[11] Sec. 265 provides, in relevant part, as follows:

SEC. 265. EXPENSES AND INTEREST RELATING TO TAX-EXEMPT INCOME.

No deduction shall be allowed for—

(1) EXPENSES.—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under sec. 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

taxation under sec. 501(c)(3), I.R.C. 1954, but would gain additional benefit from "operating foundation" status, including an exemption from excise tax under sec. 4942, I.R.C. 1954. See secs. 4942(a) and 4942(a)(1), I.R.C. 1954.

P anticipated $6,600 annual interest income, $6,000 of which was to be applied to scholarships and $600 to administrative expenses. R contended that the moneys P expended as scholarships were not "qualifying distributions * * * directly for the active conduct of the activities constituting the purpose or function for which it [P] is organized and operated" under sec. 4942(j)(3)(A), I.R.C. 1954. Additionally, R contended that P failed all of the 3 tests (the assets, endowment, and public supports tests), one of which P must pass to obtain "operating foundation" status. *Held*: P maintains a "significant involvement in a[n] * * * activity in connection with which * * * scholarships are awarded." See secs. 53.4942(b)-1(b)(2) and 53.4942(b)-1(b)(2)(ii)(A), Foundation Excise Tax Regs. Accordingly, amounts P expends for scholarships constitute "qualifying distributions * * * directly for the active conduct of the activities constituting the purpose or function for which it [P] is organized and operated" under sec. 4942(j)(3)(A), I.R.C. 1954. *Held, further*, P is entitled to utilize the "endowment test" of sec. 4942(j)(3)(B), I.R.C. 1954, and to "operating foundation" status.

David M. Wooldridge and *Allan J. Chappelle*, for the petitioner.

Dianne I. Crosby, for the respondent.

OPINION

GERBER, *Judge*: Petitioner brings this action for a declaratory judgment, pursuant to section 7428,[1] seeking a redetermination of respondent's adverse ruling as to petitioner's status as an operating foundation under section 4942(j)(3). The record in this case consists of a stipulated administrative record with attached exhibits, and is incorporated herein by this reference. See Rules 210(b)(11) and 217(a).

Petitioner, the "Miss Elizabeth" D. Leckie Scholarship Fund (sometimes referred to as the foundation or the trust), is a charitable trust created by an agreement executed

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[1] All section references are to the Internal Revenue Code of 1954 as amended. All Rule references are to the Tax Court Rules of Practice and Procedure.

November 1, 1982,[2] under the laws of the State of Alabama (the trust agreement). Ettie B. Cheatham (Cheatham) established the foundation and serves as the trustee. Petitioner's principal office is at 604 East Commerce Street, Greenville, Alabama 36037.

On September 9, 1983, respondent issued a determination letter to petitioner, finding that the foundation is exempt from Federal income tax under section 501(c)(3) and that the foundation is a private foundation within the meaning of section 509(a). On November 29, 1983, respondent issued a final adverse ruling as to petitioner's status as an "operating foundation" within the meaning of section 4942(j)(3).

Petitioner subsequently exhausted all of its administrative remedies. On February 29, 1984, petitioner filed a petition in this Court seeking a declaratory judgment as to respondent's final adverse determination letter.

Since this is an action for a declaratory judgment, our decision is based solely on the administrative record. The facts, as stipulated, are assumed to be true. Rule 217. The burden of proof as to the grounds set forth in the notice of determination lies with petitioner. Rule 217.

Butler County is one of the poorest counties in Alabama.[3] Many of the children do not return to the county once they have completed their education. The foundation seeks to raise the standard of living in Butler County (the county) by assisting the children of its residents in obtaining a college education and encouraging those students to return to the county to live. The foundation accomplishes this objective by providing funds for their college educational expenses, getting the students involved in local civic affairs and business, and assisting them in finding summer employment in the county.

The trust agreement provides that a Board of Examiners (the board) be appointed, consisting of five members, who are resident citizens of Butler County. The board's duties include doing any and all acts it deems appropriate to promote Butler County as the place such students should live and work, meeting annually to select scholarship recipients,[4] and determining the amount of each scholarship.[5] Other specific duties of the board, as enumerated in the trust agreement, are to contact scholarship recipients periodically as well as to monitor their progress.

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[2] The operation of the trust created therein was made retroactive to Dec. 17, 1981, the day that Ettie B. Cheatham, the donor, made a series of cash contributions to the trust. The trust was formed on Nov. 15, 1981.

[3] In 1982, per capita income in Butler County, Alabama, was $7,174, while the average per capita income in the United States was $11,100. Out of 67 counties in Alabama, 45 counties had higher per capita income than Butler County. See 64 Survey of Current Business, No. 4, at 30-35 (April 1984).

In addition, the board agreed to undertake particular activities on a volunteer basis. These activities include: Assisting scholarship recipients in finding summer jobs in Butler County; introducing recipients to Butler County officials, business, and professional leaders; conducting tours of Butler County and highlighting its positive aspects; compiling data promoting Butler County as a desirable place to live; compiling statistics regarding the role and success of the foundation in accomplishing the return of individuals to Butler County to work and reside; and upgrading the program which encompasses taking all steps necessary and appropriate to achieve its objective of getting well educated people to live and work in Butler County. The only salaried employee is the trust's secretary. Since the trust does not provide adequate income to finance all of the activities required to accomplish its objectives, a substantial amount of free time must be provided by unpaid board members and volunteers.

Petitioner was initially funded by a charitable contribution of investments worth $135,986.11, donated by Cheatham.[6] All interest income generated by the trust assets is used to pay petitioner's administrative expenses and to provide scholarships.

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[4] The trust agreement provides that in selecting scholarship recipients, the board should consider (in the order named) the potential recipient's need, character, ability to successfully complete a college education; and if the potential recipient previously attended college, the record of that student while in college.

[5] The trust agreement limits the amount of scholarship moneys available to $1,000 per recipient, and provides that the moneys are to be paid directly to the college or university and applied first to tuition payable, then to books, and finally, any excess is to be paid to the recipient for living expenses.

[6] As of Dec. 31, 1981, the fund assets consisted of the following:

Savings account, Greenville Bank (#411-4023-2)	$500.28
Williams mortgage loan	36,845.26
Certificate of deposit (#20987)	49,835.19
Certificate of deposit (#23223)	2,286.82
Certificate of deposit (#24698)	45,018.07
Certificate of deposit (#24810)	1,500.49
Total	135,986.11

Petitioner's sole source of income since the initial endowment has been interest earned on the endowment. Petitioner expects to earn $6,600 interest income annually, with projected annual expenses of $6,000 in scholarships and $600 in administrative expenses.

The issue we must decide is whether petitioner qualifies as a "private operating foundation" under section 4942(j)(3). Respondent argues that the moneys petitioner spends on scholarships ($6,000 out of $6,600 income per year) are not "qualifying distributions * * * directly for the active conduct of the activities constituting the purpose or function for which it [petitioner] is organized and operated."[7] Sec. 4942(j)(3)(A). Thus, respondent argues, petitioner is not entitled to "private operating foundation" status. Furthermore, respondent contends that petitioner fails each of the three tests (the assets, endowment, and public support tests), one of which petitioner must pass to attain "operating status." Petitioner argues that its scholarship grants are qualifying distributions as required by section 4942(j)(3) and defined in section 53.4942(b)-1(b)(2)(ii), Foundation Excise Tax Regs., and that it meets the endowment test, thereby fulfilling all statutory requirements. Alternatively, petitioner contends that section 53.4942(b), Foundation Excise Tax Regs., is invalid.

We find that petitioner meets the requirements of section 4942(j)(3) and the regulations promulgated thereunder. Accordingly, petitioner is entitled to "private operating foundation" status.[8]

Section 4942 is part of the detailed statutory provisions of the Tax Reform Act of 1969[9] which were designed to combat then existing abuses in the formation and operation of exempt organizations. One such abuse was the availability of a current deduction for the donor with a corresponding ability by the foundation to delay actual distribution for charitable purposes. This could occur when a private foundation invested in assets that produced no curr income, and made no distributions. See S. Rept. 91- (1969), 1969-3 C.B. 423, 446, 447. Accordingly, section 4 requires that certain private foundations make a minim level of charitable distributions. It further provides that initial tax and an additional tax be imposed if such priv foundation fails to currently distribute its distributa amount in the form of qualifying distributions.[10]

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[7] That the scholarships are qualifying distributions within the meaning of sec. 4942(j)(3) as defined in sec. 4942(g)(1) and (2) is not at issue. That the scholarships are made directly for the active conduct of the activities constituting the purpose or function for which petitioner is organized and operated is at issue. For convenience, however, we sometimes phrase the issue as simply whether the scholarships are qualifying distributions.

[8] We, therefore, do not find it necessary to consider the validity of sec. 53.4942(b)-1(b)(2)(ii)(B), Foundation Excise Tax Regs.

[9] Pub. L. 91-172, 83 Stat. 487.

Section 4942(a)(1), however, exempts "operating foun tions" from these requirements. Section 4942(j)(3) defi "operating foundations"[11] as follows:

> (3) OPERATING FOUNDATION.—For purposes of this section, the "operating foundation" means any organization—
>
> (A) which makes qualifying distributions (within the meaning paragraph (1) or (2) of subsection (g)) *directly for the active conduc the activities constituting the purpose or function for which i organized and operated* equal to substantially all of the lesser of—
>
> (i) its adjusted net income (as defined in subsection (f)), or
>
> (ii) its minimum investment return; and
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> * * * * * * *
>
> [B](ii) which normally makes qualifying distributions (within meaning of paragraph (1) or (2) of subsection (g)) directly for the ac conduct of the activities constituting the purpose or function for w it is organized and operated in an amount not less than two-third its minimum investment return (as defined in subsection (e)) * * *
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> * * * * * * *
>
> Notwithstanding the provisions of subparagraph (A), if the qualif distributions (within the meaning of paragraph (1) or (2) of subsection of an organization for the taxable year exceed the minimum investr return for the taxable year, clause (ii) of subparagraph (A) shall not a unless substantially all of such qualifying distributions are made dire for the active conduct of the activities constituting the purpos function for which it is organized and operated.
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> [Emphasis added.]

Section 53.4942(b)-1(b)(1), Foundation Excise Tax Re enunciates the general rule that qualifying distributions not made "'directly for the active conduct activities' unless such qualifying distributions are used the foundation itself, rather than by or through one or more grantee organizations which receive such qualifying distributions directly or indirectly from such foundation.”

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[10] See *Trust Under the Will of Mabury v. Commissioner*, 80 T.C. 718 (1983), for a discu of the imposition of tax under sec. 4942 and its effect.

[11] Operating foundation status yields many advantages. Besides not being subject to 4942 tax, a foundation is more likely to attract additional support from other grant-ma foundations, eligible to receive 50-percent charitable contributions, and eligible for favorable rules on gifts of appreciated property.

Section 53.4942(b)-1(b)(2), Foundation Excise Tax Regs., provides an exception to the general rule. That regulation considers “Payments to individual beneficiaries,” and provides in pertinent part:

> (i) *In general.* If a foundation makes or awards grants, scholarships, or other payments to individual beneficiaries * * * to support active programs conducted to carry out the foundation's charitable, educational, or other similar exempt purpose, such grants, scholarships, or other payments will be treated as qualifying distributions made directly for the active conduct of exempt activities for purposes of paragraph (a) of this section only if the foundation, apart from the making or awarding of the grants, scholarships, or other payments, otherwise maintains some significant involvement (as defined in subdivision (ii) of this subparagraph) in the active programs in support of which such grants, scholarships, or other payments were made or awarded. *Whether the making or awarding of grants, scholarships, or other payments constitutes qualifying distributions made directly for the active conduct of the foundation's exempt activities is to be determined on the basis of the facts and circumstances of each particular case. The test applied is a qualitative, rather than a strictly quantitative, one. Therefore, if the foundation maintains a significant involvement (as defined in subdivision (ii) of this subparagraph) it will not fail to meet the general rule of subparagraph (1) of this paragraph solely because more of its funds are devoted to the making or awarding of grants, scholarships, or other payments than to the active programs which such grants, scholarships, or other payments support.* However, if a foundation does no more than select, screen, and investigate applicants for grants or scholarships, pursuant to which the recipients perform their work or studies alone or exclusively under the direction of some other organization, such grants or scholarships will not be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities. The administrative expenses of such screening and investigation (as opposed to the grants or scholarships themselves) may be treated as qualifying distributions made directly for the active conduct of the foundation's exempt activities.
>
> (ii) *Definition.* For purposes of this subparagraph, a foundation will be considered as maintaining a *“significant involvement” in a charitable, educational, or other similar exempt activity in connection with which grants, scholarships, or other payments are made or awarded if—*
>
> (A) *An exempt purpose of the foundation is the relief of poverty * * * and its exempt activities are designed to ameliorate conditions among a poor * * * class of persons * * *, the making or awarding of the grants or other payments to accomplish such exempt purpose is direct and without*

> *the assistance of an intervening organization or agency, and the foundation maintains a * * * voluntary staff of * * * personnel who supervise and direct the activities described in this subdivision (A) on a continuing basis * * **
>
> [Emphasis added.]

The controversy centers on whether the foundation's granting of scholarships is a "qualifying distribution * * * directly for the active conduct of the foundation's exempt activities." We find that it is.

Respondent argues that the foundation merely screens and selects applicants. Petitioner, on the other hand, contends that it maintains a significant involvement in its exempt activity, and, therefore, the scholarship amounts should be considered as qualifying distributions. We agree with petitioner.

The determination of whether the scholarships made by petitioner constitute "qualifying distributions expended directly for the active conduct of the foundation's exempt activities," is a purely factual one, made on a qualitative basis. Sec. 53.4942(b)-1(b)(2), Foundation Excise Tax Regs. An exempt organization, such as petitioner, that uses more of its funds for scholarships than for any other purpose can still be considered a private operating foundation if it maintains a significant involvement in an exempt activity for which such scholarships are awarded. "Significant involvement" occurs if an exempt purpose of the foundation is to relieve poverty and its conditions among a poor class of persons, the making of such payments is direct, and the foundation has personnel who supervise and direct the activities described on a continuing basis. Sec. 53.4942(b)-1(b)(2)(ii)(A), Foundation Excise Tax Regs.

A careful review of the record is necessary to determine whether the foundation maintains a significant involvement in an exempt activity for which scholarships are awarded. Whether petitioner maintains a significant involvement is a factual determination. Sec. 53.4942(b)-1(b)(2), Foundation Excise Tax Regs. A primary objective of the foundation is to improve the county. This objective is sought to be accomplished by giving Butler County high school students a chance to receive a college education. The trust agreement sets forth the criteria by which the potential scholarship beneficiaries are to be selected. The most important consideration is need. After selection of the scholarship recipients, the board, on a volunteer basis, maintains contact with the recipients, assists them in finding summer jobs in Butler County, introduces them to officials, business, and professional leaders of the county, conducts county tours and compiles data and statistics promoting the county as a desirable place to live and work. Such activity hardly qualifies as mere selection, screening, and investigation of applicants. We believe that an exempt purpose of petitioner is to relieve poverty in a poor class of people through aiding needy students in Butler County to obtain a college education and through encouraging those students to return to the county, thus raising the standard of living. Accordingly, we find that under these facts, petitioner's program amounts to a "significant involvement" as defined by section 53.4942(b)-1(b)(2)(ii)(A), Foundation Excise Tax Regs.[12]

In addition, petitioner meets the requirements of the endowment test. Section 53.4942(b)-2(b)(1), Foundation Excise Tax Regs., provides that a foundation will satisfy the endowment test if it normally makes "qualifying distributions (within the meaning of paragraph (a)(2) of sec. 53.4942(a)-3) directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purpose in an amount not less than two-thirds of its minimum investment return."

Respondent argues that petitioner should not be allowed to use the endowment test because the legislative history indicates that petitioner is not the type of exempt organization for which this test was intended and that, in any event, petitioner fails to satisfy this test because petitioner does not expend the required amount of funds "directly for the active conduct of its activities." Rather, respondent argues, Congress intended this alternative test to apply to organizations whose personal services are so great in relation to their charitable assets that they are unable to pay for the personal services out of their small endowment. See S. Rept.

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[12] We, therefore, need not consider whether petitioner maintained a "significant involvement" as outlined in sec. 53.4942(b)-1(b)(2)(ii)(B), Foundation Excise Tax Regs.

91-552 (1969), 1969-3 C.B. 423. We disagree with respondent's analysis.

First, we consider respondent's argument that Congres did not intend that an organization with petitioner's patter of expenditures be able to take advantage of the endowmen test. Respondent suggests that only certain types of exemp organizations should be able to take advantage of th alternative tests. Although the legislative history indicate that the Senate Finance Committee amendment introducin the endowment test was in response to the situatio respondent suggests, we do not believe that the amendmen was intended to limit the test to a specific type c organization. Neither the statute nor the regulations support respondent's argument.

We do not take as narrow a view of the application of th endowment test as does respondent. Where a statute i clear on its face, especially when that statute is part of complex set of statutory provisions marked by a hig degree of specificity, we require unequivocal evidence c legislative purpose before construing the statute so as t override the plain meaning of the words used therei *Huntsberry v. Commissioner*, 83 T.C. 742, 747-748 (1984 Accordingly, we refuse to construe section 4942(j)(3)(B)(ii) a applying only to certain types of exempt organizations. Se *Garrison v. Commissioner*, 86 T.C. 764 (1986).

Having decided that petitioner is entitled to use th endowment test, we must now consider whether petitione meets the requirements of that test. Petitioner will satisf the endowment test if it normally makes qualifying distributions directly for the active conduct of activities constituting its exempt purpose in an amount not less tha two-thirds of its minimum investment return.[13] Petitione therefore, must make qualifying distributions of approximately $4,533[14] to satisfy the test.[15] Petitioner spend

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[13] Minimum investment return is defined in sec. 4942(e) and in sec. 53.4942(a)-2(c Foundation Excise Tax Regs. Generally, an organization's minimum investment return is percent of the fair market value of the organization's assets, other than those used directly i carrying on its exempt activities. Sec. 53.4942(a)-2(c), Foundation Excise Tax Regs.

[14] In this case, minimum investment return is determined by multiplying petitioner's tota investments by 5 percent. That figure is $6,799.31 ($135,986.11 x .05). Two-thirds of tha amount (the minimum amount of qualifying distributions that petitioner must make to pas the endowment test) is approximately $4,533.

[15] Respondent, without authority, apparently contends that minimum investment return i an actual income requirement, and that petitioner therefore fails the endowment test becaus

$6,000 each year in scholarships and $600 in expenses related thereto.

We have already determined that under section 4942(j)(3)(A) the scholarship grants in question are qualifying distributions made directly for the active conduct of petitioner's exempt activities. Section 53.4942(b)-2(b)(2), Foundation Excise Tax Regs., states that the phrase at issue is to be given the same meaning as in paragraph (b) of section 53.4942(b)-1, Foundation Excise Tax Regs. Petitioner, therefore satisfies the endowment test as stated under section 4942(j)(3)(B)(ii).

Accordingly, petitioner is qualified as a private operating foundation as defined by section 4942(j)(3).

Decision will be entered for the petitioner.

ESTATE OF PAULINE E. BULLARD, DECEASED, VICTOR M. BULLARD, EXECUTOR, AND VICTOR M. BULLARD, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 24933-83. Filed July 31, 1986.

Ps sold certain "capital gain property" to a charitable institution for less than fair market value and elected to apply the "appreciation reduction" rules of sec. 170(e)(1), I.R.C. 1954 as amended, to the bargain sale. *Held*: The amount of Ps' charitable contribution is reduced by 50 percent of the unrealized appreciation of only the "contributed" portion of the property. Sec. 1011(b), I.R.C. 1954, as amended, applies to the "sold" portion of the property. *Held, further*, to the extent that secs. 1.170A-4(c) and 1.1011-2, Income Tax Regs., provide otherwise, the regulations are invalid.

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petitioner's expected annual income is less than its minimum investment return (5 percent of petitioner's assets). This argument lacks merit. Minimum investment return is defined in terms of assets, not income, and imposes no actual income requirement. See sec. 4942(e). The endowment test requires only that petitioner "normally make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated in an amount not less than two-thirds of its minimum investment return." We note, also, that respondent's regulations do not consider an organization's actual income when determining whether an organization satisfies the endowment test. See Sec. 53.4942(b)-2(b)(3), Foundation Excise Tax Regs.

Victor M. Bullard, pro se.
Erin Collins, for the respondent.

OPINION

COHEN, *Judge*: Respondent determined deficiencies in Victor M. and Pauline E. Bullard's Federal income taxes for 1978 and 1979 of $2,397 and $8,647, respectively. The only issue for decision is the availability of a charitable contribution deduction under section 170[1] with respect to the "bargain sale" of certain appreciated capital gain property.

The parties submitted this case fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure.

Victor M. and Pauline E. Bullard filed joint Federal income tax returns for 1977, 1978, and 1979 with the Internal Revenue Service Center in Fresno, California. Pauline E. Bullard died on April 30, 1982, and Victor M. Bullard, a resident of Palm Desert, California, is executor of her estate. The term "petitioners" herein refers to Victor and Pauline Bullard or to Victor Bullard and the Estate of Pauline Bullard, as appropriate.

On May 24, 1977, petitioners sold their interest in Weimar Medical Center (Weimar) to the Hewitt Research Center (Hewitt), a nonprofit corporation affiliated with the Seventh-Day Adventist Church. Weimar included both "capital gain property" as defined in section 170(b)(1)(C)(iv) and "ordinary income property" as defined in section 1.170A-4(b)(1), Income Tax Regs. To reflect the previous transfer of an interest in Weimar from petitioners to Ureeken and Lakeport Hospital, Ureeken and Lakeport Hospital received a portion of the proceeds from the sale of Weimar. The following table summarizes petitioners' sale of Weimar to Hewitt:

	Capital gain property	*Ordinary income property*	*Total*
Fair market value			$1,325,000
Less: Portion attributable to Ureeken and Lakeport Hospital			150,000
Fair market value Petitioners' interest	$1,106,478	$68,522	1,175,000

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during 1977 through 1979.

	Capital gain property	*Ordinary income property*	*Total*
Sales proceeds			$1,150,000
Less: Portion attributable to Ureeken and Lakeport Hospital			150,000
Proceeds from sale of petitioners' interest	$941,684	$58,316	1,000,000
Contribution portion	164,794	10,206	175,000
Fair market value	1,106,478	68,522	
Cost plus improvements	698,024	78,727	
Depreciation—per return	[2](43,392)	(9,841)	
Adjusted basis	654,632	68,886	
Total gain	451,846	(364)	

In their 1977 Federal income tax return, petitioners elected under section 170(b)(1)(C)(iii) to apply section 170(e)(1) to the contribution portion of the "bargain sale" of the Weimar capital gain property to Hewitt and reported a charitable contribution deduction as a result of the sale. Petitioners applied section 1011(b) to the portion of the property sold and reported the resulting gain under the installment method. Respondent does not contest petitioners' use of the installment method but argues that no contribution deduction is allowable and section 1011(b) is inapplicable.

The issue in this case involves the interaction between section 170(e)(1), which limits the deduction for the charitable contribution of certain appreciated property, and section 1011(b), which requires allocation of basis to determine gain resulting from a bargain sale to charity, with respect to the Weimar capital gain property. The treatment of the ordinary income property is not disputed. The deficiencies determined for 1978 and 1979 resulted from carryovers from 1977 to those years under section 170(d).

Section 170(a) allows a deduction for any charitable contribution, defined in section 170(c) to include a contribution or gift to certain charitable organizations. Under section 170(b)(1)(C) and (E), the taxpayer's annual deduction for the contribution of capital gain property (i.e., any capital asset the sale of which at fair market would result in long-term capital gain) generally is limited to 30 percent of the taxpayer's adjusted gross income. If the taxpayer elects application of the "appreciated property" rules of section 170(e)(1) to such contributions, however, the annual deduction limitation is instead the general 50-percent standard of section 170(b)(1)(A). Sec. 170(b)(1)(C)(iii).

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[2] The stipulation filed by the parties reported this figure as (34,392). The remainder of the stipulated figures and petitioners' 1977 return indicate that the correct amount is (43,392) as found above.

Section 170(e)(1) provides as follows:

> SEC. 170(e). CERTAIN CONTRIBUTIONS OF ORDINARY INCOME AND CAPITAL GAIN PROPERTY.—
>
> (1) GENERAL RULE.—The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—
>
> (A) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution), and
>
> (B) in the case of a charitable contribution—
>
> (i) of tangible personal property, if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or
>
> (ii) to or for the use of a private foundation (as defined in section 509(a)), other than a private foundation described in subsection (b)(1)(D),
>
> 50 percent (62⅓ percent, in the case of a corporation) of the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).
>
> For purposes of applying this paragraph (other than in the case of gain to which section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) applies), property which is property used in the trade or business (as defined in section 1231(b)) shall be treated as a capital asset.

Application of section 170(e)(1) to the contribution of property thus requires that the amount of the charitable contribution be reduced by 50 percent of the gain that would have been long-term capital gain, and 100 percent of the gain that would not, if the taxpayer had sold the property at its fair market value.[3]

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[3] As the statutory language indicates, absent the election under sec. 170(b)(1)(C)(iii), sec. 170(e)(1) applies to contributions of capital gain property only if the donee is a private

A taxpayer may make a charitable contribution by selling property to a charity for less than its fair market value. The amount of the charitable contribution resulting from such a "bargain sale" generally is the excess of the fair market value of the property over its sales price. See *Stark v. Commissioner*, 86 T.C. 243, 255-256 (1986); *Knott v. Commissioner*, 67 T.C. 681 (1977); *Waller v. Commissioner*, 39 T.C. 665, 677 (1963). Section 1011(b) provides as follows with respect to bargain sales:

> SEC 1011(b). BARGAIN SALE TO A CHARITABLE ORGANIZATION.—If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

In the present case, respondent does not deny that petitioners made a charitable contribution to a qualifying organization through the bargain sale of Weimar to Hewitt. In dispute is the amount by which petitioners' contribution must be reduced under section 170(e)(1). According to respondent, section 170(e)(1) precludes any deduction for the contribution of the Weimar capital gain property. As petitioners admit, this result is prescribed by the regulations under sections 170(e) and 1011(b), which provide in relevant part as follows:

> Sec. 1.170A-4. Reduction in amount of charitable contributions of certain appreciated property.
>
> (c) *Allocation of basis and gain*— * * *.
>
> * * * * * * *
>
> (2) *Bargain sale.* (i) If there is a bargain sale of property to the charitable organization and if section 1011(b) and sec. 1.1011-2 apply, then for purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property there shall be allocated under section 1011(b) to the contributed portion of the property the portion of the adjusted basis which is not allocated under section 1011(b) to the noncontributed portion of the property for purposes of determining gain from the bargain sale. The portion of the adjusted basis which is so allocated to the contributed portion of the property shall be that portion of the adjusted basis of the entire property which bears the same ratio to the total adjusted basis as the fair market value of the

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foundation or uses the property in a manner unrelated to its tax-exempt function or purpose. Sec. 170(e)(1)(B).

contributed portion of the property bears to the fair market value of the entire property. For purposes of applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property in such a case, there shall be allocated to the contributed portion the amount of gain which is not recognized on the bargain sale but which would have been recognized as ordinary income or long-term capital gain if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

(ii) *If there is a bargain sale of property to the charitable organization and if section 1011(b) and sec. 1.1011-2 do not apply, the taxpayer's adjusted basis of the entire property shall be allocated to the noncontributed portion of the property in accordance with paragraph (e) of sec. 1.1001-1 for purposes of determining gain from the sale. In such case, no portion of the adjusted basis shall be allocated to the contributed portion of the property.*

(iii) The term "bargain sale", as used in this subparagraph, means a transfer of property which is in part a sale or exchange of the property and in part a charitable contribution, as defined in section 170(c), of the property.

[Emphasis supplied.]

Sec. 1.1011-2. Bargain sale to a charitable organization.

(a) *In general.* (1) If for the taxable year a charitable contributions deduction is allowable under section 170 by reason of a sale or exchange of property, the taxpayer's adjusted basis of such property for purposes of determining gain from such sale or exchange must be computed as provided in section 1011(b) and paragraph (b) of this section. *If after applying the provisions of section 170 for the taxable year, including the percentage limitations of section 170(b), no deduction is allowable under that section by reason of the sale or exchange of the property, section 1011(b) does not apply and the adjusted basis of the property is not required to be apportioned pursuant to paragraph (b) of this section.* In such case the entire adjusted basis of the property is to be taken into account in determining gain from the sale or exchange, as provided in sec. 1.1001-1(e). *In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year for such purposes, that section is to be applied without regard to this section and the amount by which the contributed portion of the property must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange.*

* * * * * * *

(b) *Apportionment of adjusted basis.* For purposes of determining gain on a sale or exchange to which this paragraph applies, the adjusted basis of the property which is sold or exchanged shall be that portion of the adjusted basis of the entire property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. The amount of such gain which shall be treated as

> ordinary income (or long-term capital gain) shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of the sale or exchange as the amount realized on the sale or exchange bears to the fair market value of the entire property at such time. The terms "ordinary income" and "long-term capital gain", as used in this section, have the same meaning as they have in paragraph (a) of sec. 1.170A-4. For determining the portion of the adjusted basis, ordinary income, and long-term capital gain allocated to the contributed portion of the property for purposes of applying section 170(e)(1) and paragraph (a) of sec. 1.170A-4 to the contributed portion of the property, and for determining the donee's basis in such contributed portion, see paragraph (c)(2) and (4) of sec. 1.170A-4. For determining the holding period of such contributed portion, see section 1223(2) and the regulations thereunder.
>
> [Emphasis supplied.]

The regulations thus provide that, in the case of a bargain sale of appreciated property to which section 170(e)(1) applies, no deduction is allowable unless the contribution (i.e., excess of fair market value over sales price) exceeds the "appreciation reduction" (i.e., 50 percent and 100 percent of the inherent capital gain and ordinary income, respectively) for the *entire* property. Examples in the regulations confirm this rule. See secs. 1.170A-4(d), examples(*5*)-(*6*), and 1.1011-2(c), examples (*4*)-(*7*), Income Tax Regs.

In the present case, the amount of petitioners' contribution resulting from the bargain sale of the Weimar capital gain property before application of section 170(e)(1), $164,794, is less than 50 percent of the total inherent gain in such property, $451,846. Therefore, petitioners will be entitled to no charitable contribution deduction unless this aspect of the regulations is invalid.

In urging invalidation of the regulations, petitioners argue that, under section 170(e)(1), their contribution of the capital gain property should be reduced only by 50 percent of the gain inherent in the contributed portion of such property. Because the contributed portion of the captial gain property possessed a fair market value of $164,794 and a basis of $97,498 ($164,794/$1,106,478 × $654,632), petitioners' contribution under section 170(e)(1) would be the "actual" contribution, $164,794, less one-half of $67,296 or $131,146. As is discussed further below, this method is consistent both with the basis allocation rules of section 1.170A-4(c)(1), Income Tax Regs., which apply in all cases except bargain sales,[4] and with the regulations' allocation provisions for bargain sales where the amount of the contribution exceeds the appreciation reduction under section 170(e)(1).

The Supreme Court has articulated the following standard for determining the validity of Treasury regulations:

> regulations command our respect, for Congress has delegated to the Secretary of the Treasury, not to this Court, the task "of administering the tax laws of the Nation." *United States v. Cartwright*, 411 U.S. 546, 550 (1973); accord, *United States v. Correll*, 389 U.S. 299, 307 (1967); see 26 U.S.C. sec. 7805(a). We therefore must defer to Treasury Regulations that "implement the congressional mandate in some reasonable manner." *United States v. Correll, supra* at 307; accord, *National Muffler Dealers Assn. v. United States*, 440 U.S. 472, 476-477 (1979). To put the same principle conversely, Treasury Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); accord, *Fulman v. United States*, 434 U.S. 528, 533 (1978); *Bingler v. Johnson*, 394 U.S. 741, 749-751 (1969). * * * [*Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981).]

Respondent characterizes the regulations in issue as "legislative," i.e., emanating from a specific congressional grant of authority and not merely from the Treasury's general rule-making power under section 7805(a), a characterization which we shall assume correct for purposes of our decision.[5] Moreover, the regulations were issued soon after enactment of the statutory provisions and have survived numerous amendments to section 170(e). Although we have found no indication that Congress subsequently approved, or even considered, the aspect of these long-standing regulations that is in issue herein, the regulations are entitled to the highest standard of deference. See, e.g., *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982) (legislative regulation entitled to greater deference); *Watt v. Alaska*, 451 U.S. 259, 272-273 (1981) (contemporaneous interpretation by administrative agency that proposed the legislation); *United States v. Correll*, 389 U.S. 299, 305-306 (1967) (legislative reenactment doctrine).

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[4] Sec. 1.170A-4(c)(1), Income Tax Regs., provides as follows:

> (c) *Allocation of basis and gain*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph—
>
> (i) If a taxpayer makes a charitable contribution of less than his entire interest in appreciated property, whether or not the transfer is made in trust, as, for example, in the case of a transfer of appreciated property to a pooled income fund described in section 642(c)(5) and sec. 1.642(c)-5, and is allowed a deduction under section 170 for a portion of the fair market value of such property, then for purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property the taxpayer's adjusted basis in such property at the time of the contribution shall be allocated under section 170(e)(2) between the contributed portion of the property and the noncontributed portion.
>
> (ii) The adjusted basis of the contributed portion of the property shall be that portion of the adjusted basis of the entire property which bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property.
>
> (iii) The ordinary income and the long-term capital gain which shall be taken into account in applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property shall be the amount of gain which would have been recognized as ordinary income and long-term capital gain if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

However limited our standard of review, a regulation nevertheless is not valid unless it is reasonable and consistent with the statute's plain language, origin, and purpose. *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 477 (1979). As we stated in *State of Washington v. Commissioner*, 77 T.C. 656, 675-676 (1981), affd. 692 F.2d 128 (D.C. Cir. 1982):

> even if a regulation is not "technically inconsistent" with the statutory language it seeks to interpret, if it is "manifestly inconsistent" with what Congress "surely * * * intended" to do, then it cannot stand. *United States v. Cartwright*, 411 U.S. 546, 557 (1973).
>
> * * * See *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 93-94 (1934), where the Supreme Court stated—
>
> "The intention of the lawmaker controls in the construction of taxing acts as it does in the construction of other statutes, and that intention is to be ascertained, not by taking the word or clause in question from its

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[5] Sec. 170(e)(2) provides:

(2) ALLOCATION OF BASIS.—For purposes of paragraph (1), in the case of a charitable contribution of less than the taxpayer's entire interest in the property contributed, the taxpayer's adjusted basis in such property shall be allocated between the interest contributed and any interest not contributed in accordance with regulations prescribed by the Secretary.

Presumably under this authority, sec. 1.170A-4(c)(2), Income Tax Regs., allocates basis in the case of bargain sales between the "contributed" and "sold" portions of the property by reference to sec. 1.1011-2, Income Tax Regs. It is not clear, however, that Congress intended sec. 170(e)(2) to apply to contributions other than those excepted from the general rule of sec. 170(f) prohibiting any deduction for the contribution of less than the taxpayer's entire interest in the property. The operative language of sec. 170(e)(2) is identical to that used in sec. 170(f)(3)(A), and bargain sales, unlike the typical sec. 170(f) contributions, are the subject of the allocation rule of sec. 1011(b). It similarly is not clear that, but for the exceptions of sec. 170(f)(3)(B), the general rule of sec. 170(f)(3)(A) would apply to bargain sales or that bargain sales fall within one of the exceptions. Because bargain sales are not subject to sec. 170(f)(3)(A), there exists a strong argument that authority for the basis allocation provisions *for bargain sales* arises under sec. 7805(a) and not sec. 170(e)(2).

> setting and viewing it apart, but by considering it in connection with
> context, the general purposes of the statute in which it is found,
> occasion and circumstances of its use, and other appropriate tests for
> ascertainment of the legislative will."

I. The Statutory Language

A. Section 170(e)(1)

Virtually the only argument advanced by respondent
support of the regulations is based upon the language
section 170(e). Congress provided in section 170(e)(1) th
the amount of any charitable contribution of appreciat
property must be reduced by the relevant percentage (i.
50 or 100 percent) of "the amount of gain which wou
* * * [have been realized] if *the property contributed* ha
been sold by the taxpayer at its fair market value
(Emphasis supplied.) Respondent argues that "the propert
contributed" in the case of a bargain sale must refer to th
entire property, not merely the contributed portion. H
contends that Congress would have used "the contribute
portion of the property" or a similar term had it intende
the result advocated by petitioners.

Consistent with the regulations in issue, respondent'
argument requires reduction of a charitable contributio
which in the case of a bargain sale equals the contribute
portion of the property, by the gain inherent in the enti
property, including the portion sold and not contributed. I
"the property contributed" is considered not in isolatio
but in its proper context, however, section 170(e)(1) does no
yield such an anomalous result.

The introductory language in section 170(e)(1) provide
"The amount of any *charitable contribution of propert*
otherwise taken into account under this section shall b
reduced by * * *." (Emphasis supplied.) In the case of
bargain sale, only the contributed portion of the property i
taken into account under section 170. Indeed, only tha
portion constitutes a "charitable contribution of property"
the remainder is *sold* by the taxpayer. Cases involvin
bargain sales to charity in taxable years before enactmen
of present section 170(e) confirm this interpretation. Se
Mason v. United States, 513 F.2d 25, 29 (7th Cir. 1975
("only the difference between the value of the transferre

asset and the value of the consideration received could even arguably be characterized as the 'amount of the gift' "); *Waller v. Commissioner*, 39 T.C. 665, 677 (1963) ("The amount of the gift is the difference between the fair market value of the property and the amount which the * * * [recipient] paid therefor * * * .") Thus, in using the term "the property contributed," Congress must have referred to only the *contributed portion* of bargain sale property.

The unreasonableness of the regulations based solely upon the language of section 170(e)(1) is further illustrated by the distinction drawn in section 1.170A-4(c), Income Tax Regs., between bargain sales and the paradigm contributions of "less than the taxpayer's entire interest" in the property. See *supra* notes 4 & 5. If "the property contributed" in section 170(e)(1) means the entire property, then where the taxpayer contributes a partial interest in property for which a deduction is allowable under section 170(f), the unrealized appreciation on both the contributed and the noncontributed portions should be used in computing the section 170(e)(1) reduction. Unlike the special rules for bargain sales in regulations section 1.170A-4(c)(2), however, the general rules in section 1.170A-4(c)(1), Income Tax Regs., do not prescribe such a result. The statute provides no basis for this distinction between a bargain sale, where the noncontributed portion is sold, and a contribution of a partial interest, where the noncontributed portion is retained by the taxpayer. As is indicated below in our discussion of the purpose behind section 1011(b), Congress provided in that section, *not in section 170(e)(1)*, for the special situation where the noncontributed portion is sold, not retained.

An even more fundamental problem with the regulations in light of the language of section 170(e)(1) is that the regulations define "the property contributed" inconsistently even in the sole context of bargain sales. Where, as in the present case, the reduction for appreciation under section 170(e)(1) (computed using the unrealized gain in the entire property) exceeds the contribution element of the bargain sale, "the property contributed" refers to the entire property. Where, however, the amount of the contribution exceeds the section 170(e)(1) amount, the regulations ultimately define the statutory term as only the contributed portion of the property.

This result in the latter case is best illustrated by an example from the regulations:

> *Example (4).* In 1970, B, a calendar-year individual taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. B's contribution base for 1970, as defined in section 170(b)(1)(F), is $20,000 and during such year B makes no other charitable contributions. Thus, he makes a charitable contribution to the church of $8,000 ($10,000 value - $2,000 amount realized). Since without regard to this section B is allowed a deduction under section 170 of $2,000 ($8,000 - [$10,000 value - $4,000 adjusted basis]) for his charitable contribution of $8,000 to the church, under paragraph (b) of this section the adjusted basis for determining gain on the bargain sale is $800 ($4,000 adjusted basis × $2,000 amount realized/$10,000 value of stock). Accordingly, B has a recognized short-term capital gain of $1,200 ($2,000 amount realized - $800 adjusted basis) on the bargain sale. After applying section 1011(b) and paragraphs (a)(1) and (c)(2)(i) of sec. 1.170A-4, B is allowed a charitable contributions deduction for 1970 of $3,200 ($8,000 value of gift - [$8,000 - ($4,000 adjusted basis of property × $8,000 value of gift/$10,000 value of property)]). [Sec. 1.1011-2(c), example (4), Income Tax Regs.]

In computing an initial deduction of $2,000, the example reduces the contribution by the entire inherent gain of $6,000 and thus defines "the property contributed" in section 170(e)(1) as the entire property. In ultimately allowing a deduction of $3,200, however, the example reduces the contribution only by the gain inherent in the contributed portion and thus defines the statutory term as the contributed portion of the property. (The gain inherent in the contributed portion is $6,000 × $8,000/$10,000 or $4,800, which is the difference between the $8,000 contribution and the $3,200 ultimate deduction.) Thus, the regulations require use of two inconsistent interpretations of "the property contributed" to compute the deduction in such a case, and the ultimate interpretation is inconsistent with that mandated by the regulations in the present case. There exists no indication that Congress intended the term to possess more than one meaning, and only if "the property contributed" means the contributed portion is a uniform definition applicable to all cases.[6]

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[6] If the term were ultimately defined as the entire property in cases like example (4) in sec. 1.1011-2(c), Income Tax Regs. (and thus the deduction limited to $2,000 therein), the taxpayer

B. Section 1011(b)

Respondent intimates that the introductory clause of section 1011(b), "If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale," supports the methodology prescribed by the regulations. The provisions of section 170, including section 170(e), must, of course, be applied to determine whether a charitable contribution deduction is allowable before application of section 1011(b). Section 1011(b) provides no rules, however, for the *manner* in which section 170 is to be applied. Thus section 1011(b) does not, as respondent and the regulations apparently assume, require application of section 170(e)(1) using the unrealized gain on the entire property. Petitioners' method of computing the section 170(e)(1) amount based upon the appreciation inherent in only the contributed portion likewise requires application of section 170(e) before section 1011(b).[7] Although petitioners' method results in a charitable contribution deduction, and hence application of section 1011(b), in more cases than do the regulations, this result is mandated by the history and purpose of both section 170(e) and section 1011(b), to which we now turn.

II. History and Purpose of the Statutory Provisions

As initially codified by the Revenue Act of 1962, Pub. L. 87-834, sec. 13(d), 76 Stat. 960, 1034, section 170(e) simply provided:

> SEC. 170(e). SPECIAL RULE FOR CHARITABLE CONTRIBUTIONS OF SECTION 1245 PROPERTY.—The amount of any charitable contribution

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would be denied a deduction with respect to an element of gain realized under sec. 1011(b). Presumably the drafters of the regulations recognized that this would be unreasonable.

[7] One commentator suggests that the introductory language of sec. 1011(b) merely reflects congressional intent to exclude from the section bargain sales to noncharitable donees like that in *Fincke v. Commissioner*, 39 B.T.A. 510 (1939). Although this commentator advocates the method used by petitioners, he assumes that application of sec. 170(e)(1) before sec. 1011(b) mandates use of the inherent gain in the entire property for computing the sec. 170(e)(1) reduction. See Taggart, "The Charitable Deduction," 26 Tax L. Rev. 63, 130-131 (1970). The bargain sale of zero-basis ordinary income property illustrates, however, that petitioners' approach is consistent with the statutory language. In such a case, sec. 170(e)(1) precludes any deduction and therefore application of sec. 1011(b). Moreover, various other provisions of sec. 170 might prevent a deduction in connection with a bargain sale and thus obviate application of sec. 1011(b).

Another commentator, however, interprets the statutory provisions consistently with respondent's position. See Jackson, "The New Rules Governing Bargain Sales to Charitable Organizations under the Tax Reform Act of 1969," 24 Tax Lawyer 279, 283-284 (1971).

> taken into account under this section shall be reduced by the amo
> which would have been treated as gain to which section 1245(a) applie
> the property contributed had been sold at its fair market va
> (determined at the time of such contribution).

The scope of the provision was subsequently expanded
include inherent recapture gain under sections 1250(a) a
617(d) by the Revenue Act of 1964, Pub. L. 88-272, s
231(b)(1), 78 Stat. 19, 105, and Act Relating to the Inco
Tax Treatment of Exploration Expenditures in the Case
Mining, Pub. L. 89-570, sec. 1(b)(1), 80 Stat. 759, 762 (196
respectively. Congress prescribed the present application
section 170(e)(1) to all unrealized non-long-term capital ga
and to unrealized long-term capital gain in specified situ
tions as part of the fundamental revision of section 170
the Tax Reform Act of 1969, Pub. L. 91-172, sec. 201(a), 8
Stat. 487, 549 (hereinafter the 1969 Act).

Section 1011(b) was first enacted in section 201(f) of th
1969 Act (83 Stat. 564). Prior to the effective date
section 1011(b), the taxpayer who made a bargain sale t
charity realized gain equal to the excess of the amou
realized over the entire basis in the property. See, e.g
Potter v. Commissioner, 38 T.C. 951 (1962).

Both the expansion of section 170(e) and the enactment
a bargain sale provision like section 1011(b) were initiall
recommended to Congress by the Treasury Departmen
The Treasury proposal with respect to section 170(e) woul
have applied only to potential ordinary income or short-ter
capital gain and, instead of requiring the taxpayer to reduc
the amount of the contribution, would have allowed
deduction for the full value of the property but require
recognition of the gain. See 2 U.S. Treasury Dept., Ta
Reform Studies and Proposals, 21, 38, 179-182 (Comm
Print of House Ways and Means Comm. and Senat
Finance Comm. 1969). The bill initially passed by the Hous
included a bargain sale provision identical to section 1011(b
and allowed the taxpayer who donated appreciated propert
to elect either recognition of inherent gain (as would b
required by the Treasury proposal) or reduction of th
contribution (as required by section 170(e)). Under th
House bill, the appreciated property rules applied to inherent
long-term capital gain in specified situations. See H.R.

13270, 91st Cong., 1st Sess., sec. 201(c), (d) (Aug. 2, 1969). The Senate deleted the bargain sale provision from the House bill and eliminated the option of the taxpayer contributing appreciated property to recognize gain instead of reducing his contribution.[8] See H.R. 13270, 91st Cong., 1st Sess., sec. 201(a) (Nov. 21, 1969). As ultimately codified by Congress in the 1969 Act, sections 170(e)(1) and 1011(b) were substantially identical to present law.

The Ways and Means Committee report accompanying H.R. 13270 described the purpose and operation of the appreciated property and bargain sale rules as follows:

> *3. Charitable contributions of appreciated property (sec. 201(c) and (d) of the bill and secs. 170 and 83 of the code)*
>
> *Present law.*—Under present law, a taxpayer who contributes property which has appreciated in value to charity generally is allowed a charitable contributions deduction for the fair market value of the property. A special rule (sec. 170(e)) applies, however, to gifts of certain property so that the amount of charitable contribution is reduced by the amount of gain which would have been treated as ordinary income under the recapture rules of sec. 617(d)(1) (certain mining property), sec. 1245(a) (certain depreciable tangible personal property), and sec. 1250(a) (certain depreciable real property) if the property contributed had been sold at its fair market value. Other than these exceptions, a deduction is allowed for the full value of the property and tax is not imposed on the appreciation at the time of the gift.
>
> *General reasons for change.*—The combined effect, in the case of charitable gifts of appreciated property, of not taxing the appreciation and at the same time allowing a charitable contributions deduction for the appreciation is to produce tax benefits significantly greater than those available with respect to cash contributions. The tax saving which results from not taxing the appreciation in the case of gifts of capital assets is the otherwise applicable capital gains tax which would be paid if the asset were sold. In the case of many other types of assets, this tax saving is at the taxpayer's top marginal rate. Thus, in some cases it actually is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds. This is true in the case of gifts of appreciated property, which would result in ordinary income if sold, when the taxpayer is at the high marginal tax brackets and the cost basis of the ordinary income asset is not a substantial percentage of the fair market value. For example, a taxpayer in the 70-percent tax bracket could make a gift of $100 of inventory ($50 cost

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[8] In these respects, the Senate bill was consistent with a second Treasury Department proposal. See Technical Explanation of Treasury Department Tax Proposals, *reprinted in* Hearings Before House Ways and Means Committee on Tax Reform, 91st Cong., 1st Sess. 5069, 5152-5153 (1969).

basis) and save $105 in taxes (70-percent of the $50 gain if sold, or $35, plus 70-percent of the $100 fair market value of the inventory, or $70).

In addition, if property is sold to a charity at a price less than its fair market value—a so-called bargain sale—the proceeds of the sale are treated as a return of the cost and the seller is allowed a charitable contributions deduction for the appreciation in excess of the sale price. If the sale price is above his cost basis, the taxpayer pays a tax on the difference. However, if the sale price is equal to his cost basis, the entire appreciation is taken as a deduction and no tax is paid on the gain. In either case, the taxpayer is not required to allocate the cost basis between the sale part of the transaction and the gift part of the transaction. If this were done, the taxpayer would be required to pay tax on the portion of the gain attributable to the sale part of the transaction.

The tax saving available in the case of a bargain sale of property to a charity may be illustrated by the example of a taxpayer in the 70-percent tax bracket who makes a sale of inventory with a value of $200 to a charity at its cost of $100. The taxpayer in this case would save $140 in taxes with respect to his $100 charitable gift (70 percent of the $100 gain if sold, or $70, plus 70 percent of the $100 of appreciation taken as a charitable deduction, or $70).

Your committee does not believe the charitable contributions deduction was intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax saving is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity. Moreover, an unwarranted benefit is allowed these taxpayers, who usually are in the very high income brackets. Your committee, therefore, considers it appropriate to narrow the application of the tax advantages in the case of gifts of certain appreciated property.

Explanation of provisions.—In order to remove some of the present tax advantages of gifts of appreciated property over gifts of cash, the bill provides that taxpayers making contributions of appreciated property are to be required, at their option, either (A) to reduce their charitable contribution deduction to the amount of their cost or other basis in the property or (B) to take a charitable deduction based on the fair market value of the property but to include in their tax base the untaxed appreciation with respect to the property involved. * * *

* * * * * * *

(v) Bargain sales.—In the case of so-called bargain sales to charities—where a taxpayer sells property to a charitable organization for less than its fair market value (often at its cost to the taxpayer)—the bill provides that the cost or basis of the property is to be allocated between the portion of the property "sold" and the portion of the property "given" to the charity on the basis of the fair market value of each portion. For example, if a taxpayer sold land with a fair market value of $20,000 to a charitable organization (which was not a private foundation) at his cost of

> $12,000, he would be required to allocate 60 percent of the cost ($7,200) to the portion "sold" to the charity ($12,000) and 40 percent of the cost ($4,800) to the portion "given" to the charity ($8,000). Thus, this taxpayer would be required to include $4,800 as gain from a sale of a capital asset in his tax return, and as under present law would be allowed a charitable contributions deduction of $8,000.
>
> [H. Rept. 91-413 (1969), 1969-3 C.B. 200, 234-236.]

The committee's explanation of the bargain sale rule (i.e., the final paragraph in the above excerpt) does not support the approach of the regulations in issue. The report simply indicates that basis must be allocated between the portion "given" and the portion "sold." It contains no indication that Congress intended a special rule similar to that in the regulations to apply where the property is subject to section 170(e)(1).

The Ways and Means Committee nevertheless illustrated the operation of the bargain sale rule using an example to which section 170(e)(1) would not apply, as the taxpayer in the example sold a capital asset to an organization "which was not a private foundation." Indeed, the entire explanation provides almost no explicit guidance with respect to the interaction of section 170(e)(1) and the bargain sale rule but instead describes each rule as if it existed in isolation. The bargain sale example appearing in the "*General reasons for change*" section states that the taxpayer selling inventory for less than fair market value would, but for the bargain sale rule, avoid taxes on and obtain a deduction with respect to the inherent gain. If the House's appreciated property rule were in effect, however, this presumably would not be the case, as the taxpayer would be required either to reduce his contribution or to recognize gain on the contributed portion.

The report also generally indicates that the appreciated property and bargain sale rules possess a common purpose of preventing the taxpayer from obtaining a deduction attributable to untaxed appreciation ("in excess of the sale price," in the case of bargain sales). Such statements do not specify the respective *element* of appreciation to which the two rules apply. The Finance Committee and Conference reports preserve this ambiguity by describing both the bargain sale rule and the various applications of section 170(e) as "tak[ing] the appreciation in value into account for tax purposes in gifts of appreciated property." S. Rept. 91-552 (1969), 1969-3 C.B. 423, 476; H. Rept. 91-782 (Conf.) (1969), 1969-3 C.B. 644, 654. Certain language in the legislative history thus blurs the respective parameters of section 170(e)(1) and section 1011(b).

Although describing the two rules in isolation, more specific statements of purpose contained in the Ways and Means Committee report nevertheless allow us to infer congressional intention with respect to the interaction of the sections. The report indicates that section 170(e)(1) was designed to prevent a taxpayer from realizing a windfall by giving appreciated property to charity instead of selling the property and donating the proceeds. As illustrated by the election contained in the initial House bill to recognize the appreciation and deduct the full fair market value, reduction of the contribution under section 170(e)(1) is a functional substitute for a deemed sale of the property before contribution of the proceeds. Where a transaction constitutes an actual sale, however, this "deemed sale substitute" of section 170(e)(l) is inappropriate. Moreover, Congress recognized that a bargain sale to charity included an actual sale. This recognition is implicit in the Ways and Means Committee statement that the bargain sale rule requires "the taxpayer * * * to pay tax on the portion of the gain attributable to the sale part of the transaction" and explicit in the initial Treasury proposal, which quantifies precisely the element of appreciation taken into account:

> *Present law*
>
> Under existing law a donor may *unduly magnify the tax advantages already inherent in giving appreciated property* to charity by selling the property to a charity for less than its fair value.
>
> For example, an individual in the 50 percent tax bracket owning $125,000 worth of stock which cost him $25,000 may wish to make a $100,000 gift to charity. If he donates $100,000 of stock to charity he is entitled to a $100,000 deduction against other income and the net cost of his gift is $50,000 (50 percent of $100,000). He simply ignores the fact that a portion of the value of donated stock ($80,000) represents gain which has never been included in income. On the other hand, were he to follow the bargain sale method, he would sell $125,000 of stock to the charity for the cost basis of that amount of stock, $25,000. Under the present law the $25,000 sales proceeds would first be allocated to a return of his cost, or tax basis, and, since that basis is $25,000, there would be no tax. His gift to the charity would remain a $100,000 gift,

> and his deduction would remain a $100,000 deduction. However, by following this procedure, instead of being left with $25,000 of stock with a cost basis of $5,000 (which if he later sold would cost him $5,000 in tax thus leaving him $20,000 in cash) he has $25,000 in cash. Thus, his $100,000 gift to charity has permitted him to recover his investment in the property while at the same time securing a deduction for the appreciation in value without imposition of tax.
>
> *The rule permitting the nontaxable donation of appreciated property clearly should not be permitted to shield from tax what is essentially a functionally unrelated sale of an additional amount of stock. The taxpayer intends to benefit the charity only by the net amount of the gift. He should not be allowed to enlist the charity as a buyer of his stock to save him a tax liability.*
>
> *Proposal*
>
> In such cases it is recommended that a contributor be required to allocate the basis of the property between the gift element and sale element on the basis of the fair market value of each part. If this rule were applied to the example above, since one-fifth of the total value of the stock is being sold, one-fifth of the taxpayer's basis in the stock would be allocated to the sale element of the transaction. Thus, he would be deemed to have a $5,000 basis in the stock sold to the charity for $25,000, and would be subject to tax on the resulting $20,000 gain. *Under the proposal the individual would therefore be in precisely the same position he would have been in had he donated $100,000 worth of stock to charity and simultaneously sold $25,000 more on the open market.*
>
> [2 U.S. Treasury Dept., Tax Reform Studies and Proposals 181-182 (Comm. Print of House Ways and Means Comm. and Senate Finance Comm. 1969). Emphasis supplied.]

Section 1011(b) was thus designed to recognize the sale element of a bargain sale for what it is—a sale. This section, not section 170(e)(1), ensures that the taxpayer receives no contribution deduction without realizing inherent gain on the portion of the property sold. Most importantly, the mechanism by which section 1011(b) accomplishes this result is realization of such gain, not reduction of the deduction.[9]

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[9] Indeed, the regulations generally provide that gain recognition precludes application of sec. 170(e)(1):

> Sec. 1.170A-4(a). * * * Section 170(e)(1) and this paragraph do not apply to reduce the amount of the charitable contribution where, by reason of the transfer of the contributed property, ordinary income or capital gain is recognized by the donor in the same taxable year in which the contribution is made. * * *

Requiring immediate recognition of gain on the sold portion of the property arguably would effect Congress' stated intention with respect to bargain sales. Sec. 1011(b), however, only causes *realization* of such gain; it does not prescribe when the gain is to be *recognized*. Presumably for this reason, respondent neither challenges petitioner's use of the installment

The regulations therefore understate both the deduction and the realized gain by the amount of the taxpayer's basis in the contributed portion of the property where the section 170(e)(1) amount (computed with respect to the entire property) equals or exceeds the amount of the contribution. If the property is capital gain property, the regulations also improperly reduce the contribution by 100 percent of the gain on the contributed portion. The regulations thus both preclude section 1011(b) from its intended operation and place the taxpayer in a *less* favorable position than would result if he sold the property at fair market value and then donated the excess over the bargain sales price. The latter effect distorts and unduly extends Congress' manifest purpose in enacting the "deemed sale substitute" through section 170(e)(1).[10]

Moreover, this distortion arises immediately and arbitrarily depending upon the bargain sales price. If, for example, the amount of the contribution (excess of fair market value over sales price) is $1 more than the section 170(e)(1) amount, the regulations prescribe the proper basis and gain allocations between the contributed and sold portions of the property. If the sales price is increased by $1, however (in which case section 170(e)(1) as interpreted by the regulations reduces the contribution to zero), the distortion occurs in full. Certainly this is an "arbitrary and capricious" effect, and Congress could not have intended

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method to report the gain from the Weimar property nor argues that use of such method should affect our decision herein.

[10] Assume, for example, the sale for $900 of capital gain property with a basis of $200 and a value of $1,000. Under the regulations, the taxpayer would be entitled to no contribution deduction through sec. 170(e)(1) and would realize long-term capital gain of $700, thus increasing his taxable income by $350. Had the taxpayer sold the property for $1,000 and then donated $100, he would be entitled to a $100 deduction and would realize $800 long-term capital gain, resulting in only a $300 increase in taxable income. Unlike the regulations, our holding herein yields an equivalent result: The taxpayer would be entitled to a deduction of $60 ($100 contribution less 50 percent of the $80 gain inherent in contributed portion) and would realize $720 long-term capital gain ($900 sales price less $180 basis in sold portion), thus increasing his taxable income by $300. The $50 disparity between the treatment under the regulations and the correct approach equals the 50-percent capital gain deduction times both the $20 basis in the contributed portion (which the regulations mischaracterize as reduced deduction) and the $80 gain inherent in such portion (which the regulations reduce by 100 percent).

If the property were ordinary income property, the regulations would cause only the $20 mischaracterization and, because ordinary income rates would apply, would not affect taxable income.

that such insignificant economic differences would result in such dramatic differences in tax liability.

III. Conclusion

Given the respective roles of the Treasury Department in administering the tax laws and of this Court in interpreting such laws, we do not invalidate Treasury regulations unless unreasonable and inconsistent with the language, history, and purpose of the statute. As previously discussed, the regulations in issue in this case are entitled to the highest standard of judicial deference. If the regulations constituted a reasonable interpretation of sections 170(e)(1) and 1011(b), we would be compelled to uphold them, even if petitioners' interpretation were more reasonable. See *Long v. United States*, 652 F.2d 675, 679 (6th Cir. 1981), and cases cited therein. "The choice among reasonable interpretations is for the * * * [Treasury], not the courts." National Muffler Dealers Association, Inc. v. United States, 440 U.S. 472, 488 (1979). In the present case, however, petitioners' position represents the only rational statutory interpretation. Respondent has not raised, nor have we discovered, a single rational basis for the allocation provisions in issue other than enhancement of tax revenues. That purpose, however, cannot be applied in an arbitrary manner and is inconsistent with both allowance of charitable contribution deductions and reduced effective rates of taxation of capital gain. The disputed regulations conflict with the language and purpose of the statutory provisions and lead to anomalous and inequitable tax results. Cf. *State of Washington v. Commissioner*, 77 T.C. 656 (1981), affd. 692 F.2d 128 (D.C. Cir. 1982). To the extent inconsistent with our opinion herein, sections 1.170A-4(c) and 1.1011-2, Income Tax Regs., are invalid.[11]

To reflect concessions by petitioners,

Decision will be entered under Rule 155.

Reviewed by the Court.

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[11] The Court of Appeals for the Ninth Circuit recently upheld sec. 1.1011-2(a)(3), Income Tax Regs., which provides that indebtedness on the property transferred must be included in the amount realized. *Ebben v. Commissioner*, 783 F.2d 906 (9th Cir. 1986), affg. in part and revg. in part a Memorandum Opinion of this Court. The present case does not involve that portion of the regulation.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, KÖRNER, SHIELDS, HAMBLEN, CLAPP, SWIFT, JACOBS, WRIGHT, PARR, and **WILLIAMS,** *JJ.*, agree with the majority opinion.

GERBER, *J.*, did not participate in the consideration of this case.

WRIGHT, *J.*, concurring: While I join in the majority opinion in this case, I choose to write separately in order to address the questions raised by Judge Parker's concurring and dissenting opinion. The concurring and dissenting opinion concludes that the result reached by the majority can also be reached without invalidating the regulations under sections 170(e)(1) and 1011(b). I disagree.

The analysis set forth in the concurring and dissenting opinion turns on a distinction between the elective and the mandatory application of section 170(e)(1). The taxpayers in the instant case made an election under section 170(b)(1)(C)(iii) to apply section 170(e)(1) to contributions of capital gain property made in 1977. Section 170(b)(1)(C) provides, in general, that deductions for contributions of capital gain property to which section 170(e)(1)(B) does not apply cannot exceed 30 percent of a taxpayer's contribution base for a taxable year. However, under section 170(b)(1)(C)(iii), the taxpayer may elect to have section 170(e)(1) apply to such contributions if section 170(e)(1)(B) does not otherwise apply (i.e., if the application of section 170(e)(1)(B) is not mandatory). If such an election is made, the contribution is not subject to the 30-percent limitation of section 170(b)(1)(C); however, the amount of the contribution must be reduced in accordance with section 170(e)(1). Under section 170(e)(1)(A), the amount of any charitable contribution must be reduced by the amount of gain which would have been ordinary income or short-term capital gain if the property had been sold by the taxpayer at its fair market value. Section 170(e)(1)(B) provides that the amount of a contribution of tangible personal property which is unrelated to the purpose or function of the donee organization, or a contribution to or for the use of a private foundation which is not described in section 170(b)(1)(E), must be reduced by 50 percent of the amount of gain which would have been long-term capital gain if the property had been sold by the taxpayer at its fair market value. A taxpayer has the option, therefore, when making a contribution of capital gain property (not otherwise subject to section 170(e)(1)(B)), of restricting that contribution to 30 percent of his contribution base for the taxable year under section 170(b)(1)(C), or of taking a deduction of up to 50 percent of his contribution base while being subject to the reduction requirements of section 170(e)(1).

Section 170(e)(2) provides that for purposes of section 170(e)(1), if a taxpayer contributes less than his entire interest in the property, the taxpayer's basis in such property shall be allocated between the portion contributed and any portion not contributed in accordance with the regulations. Any gain to the taxpayer on the sale portion of a charitable bargain sale is determined under section 1011(b), which provides that the adjusted basis for determining gain is that portion of the adjusted basis which bears the same ratio to the total adjusted basis as the amount realized bears to the fair market value of the property.

The regulations under these sections provide that, for a charitable bargain sale under section 170(e)(1), no charitable contribution deduction is allowable unless the contribution portion of the bargain sale exceeds the amount of the reduction required under section 170(e)(1) for the unrealized appreciation in the entire property. The majority opinion holds that the taxpayers in the instant case are entitled to claim a deduction because these regulations are invalid to the extent that they require reduction of the contribution portion of the bargain sale by a percentage of the unrealized appreciation in the entire property rather than by a percentage of the unrealized appreciation in the contributed portion. The concurring and dissenting opinion, however, attempts to circumvent this reasoning by concluding that, because the taxpayers in the instant case elected to have section 170(e)(1) apply, they are not subject to the mandatory reduction of section 170(e)(1)(B) for purposes of determining whether a deduction is allowable, and that the bargain sale at issue therefore meets the test of the regulations as written. This analysis is not supported by the statute or the regulations.[1]

If a taxpayer contributes property of the type described in section 170(e)(1)(B)(i) or 170(e)(1)(B)(ii), the charitable contribution must be reduced by 50 percent of the amount of gain which would have been long-term capital gain had the property been sold at its fair market value. The concurring and dissenting opinion concludes that, in the absence of a contribution of property described in these subparagraphs, the 50-percent reduction is not required in order to determine whether a deduction is allowable for such contribution. If section 170(e)(1)(B) does not apply when a taxpayer makes this election, the election has no effect on the determination of the allowability of such deduction because section 170(e)(1)(A) does not apply to long-term capital gain property.

Under the analysis in the concurring and dissenting opinion, section 1.1011-2(a)(1), Income Tax Regs., is correctly used to make an initial determination as to whether a charitable contribution deduction is allowable under section 170. The analysis used bifurcates section 170(e)(1) into "mandatory" and "elective" elements. Specifically, the concurring and dissenting opinion treats the application of the reduction provisions of section 170(e)(1)(B) as applying to the determination of allowability only where such reductions are mandatory; i.e., where the taxpayer contributes property of the type described in section 170(e)(1)(B)(i) or (ii). If the taxpayer has elected the application of section 170(e)(1), however, the concurring and dissenting opinion concludes that the reduction under section 170(e)(1)(B) need not be made at this point. In reaching this conclusion, the concurring and dissenting opinion assumes that the language in section 1.1011-2(a)(2), Income Tax Regs., provides a wholesale exclusion of section 170(b) for purposes of determining whether a deduction is allowable under section 1.1011-2(a)(1). Neither the statute nor the regulations at issue herein provide authority for this reasoning.

The concurring and dissenting opinion, at note 3, states that the reference to the percentage limitations of section

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[1] See also secs. 170A-4(b)(2) and 1.170A-8(d)(2)(i)(a), Income Tax Regs., treating "elective" and "mandatory" reductions under section 170(e)(1)(B) identically.

170(b) in section 1.1011-2(a)(1), Income Tax Regs., was intended to apply only with respect to bargain sales to organizations described in section 170(b)(1)(B). Section 1.1011-2(a)(2), Income Tax Regs., provides that basis must be allocated under section 1011(b) for charitable contributions which are carried over under section 170(b)(1)(C)(ii) or section 170(d) to subsequent taxable years. Because section 170(b) contains the annual percentage limitations, and therefore necessitates carryovers, the concurring and dissenting opinion concludes that section 170(b) is irrelevant to the determination of allowability under section 1.1011-2(a)(1), Income Tax Regs., except with respect to contributions of property described in section 170(b)(1)(B). However, the limited exception carved out by section 1.1011-2(a)(2), Income Tax Regs., does not support the conclusion that section 170(b) is to be disregarded entirely, including the provisions for the election to apply section 170(e)(1) contained in section 170(b)(1)(C)(iii).[2]

The election under section 170(b)(1)(C)(iii) requires a reduction of the charitable contribution portion of the bargain sale in the instant case. There is no authority in either the Code or the regulations which permits the type of analysis adopted in the concurring and dissenting opinion. In the absence of such authority, a deduction is unavailable to the petitioners herein unless the regulations which require consideration of the unrealized appreciation in the entire property are invalid. For the reasons stated in the majority opinion, I believe this to be the correct result. Thus, although the concurring and dissenting opinion reaches the correct result, for the reasons stated above, it does so for the wrong reasons. I therefore join in the majority opinion.

GOFFE, CHABOT, HAMBLEN, COHEN, and WILLIAMS, *JJ.*, agree with this concurring opinion.

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[2] The concurring and dissenting opinion reads the term "allowable" in sec.1.1011-2(a)(1), Income Tax Regs., to mean allowable without regard to the percentage limitations of sec. 170(b). The word allowable, however, cannot be so narrowly defined in this context. In drafting sec. 170 Congress used the terms "allowed" and "allowable" interchangeably. See sec. 170(a); compare sec. 170(b)(1)(A) (flush language) and sec. 170(b)(1)(B) (introductory language) with sec. 170(b)(1)(B)(ii). Further, as used in sec. 1.1011-2(a)(2), Income Tax Regs., the term "allowable" is used to mean allowable after application of the percentage limitations of sec. 170(b), because only after such limitations are applied could a contribution be carried over to a subsequent year.

PARKER, *J.*, concurring and dissenting: If my choices were between the majority's position (invalidating portions of certain regulations) or Judge Whitaker's dissent (resolving doubts in favor of the regulations), I would simply join in the dissent. However, I do not see the choices as so narrowly restricted. I would follow another route to reach the same result the majority has reached, but without invalidating any portion of the regulations and by merely applying the regulations in a different method and sequence. For the reasons set forth below, I concur in the majority's result only.

In a "bargain sale" transaction,[1] petitioners sold capital gain property with a fair market value of $1,106,478 to an organization described in section 170(b)(1)(A) for the amount of $941,684. Petitioners' adjusted basis in the property at the time of the sale was $654,632. In the year of the sale (1977), petitioners elected under section 170(b)(1)(C)(iii) to apply section 170(e)(1) to all contributions of capital gain property *to which subsection (e)(1)(B) did not otherwise apply* made by petitioners during that year.

The parties in this case apparently agree that the regulations under sections 170(e) and 1011(b) preclude petitioners from any charitable contributions deduction in connection with the bargain sale. The majority accepts the parties' litigating position as the correct reading of the regulations, and hence must decide whether or not the regulations are valid. However, I think both parties misread or misapply the regulations. Under an alternative application that I believe to be the correct one, the validity of these regulations is not in issue and petitioners are allowed a charitable contributions deduction of $131,146 in connection with the bargain sale, most of which is available as a carryover to the years before the Court.

But for petitioners' election under section 170(b)(1)(C)(iii), this case would never have arisen. See, i.e., sec. 1.1011-2(c), example (7), Income Tax Regs. Therefore, I think the appropriate issue presented in this case is whether, in a bargain sale transaction, an election under section

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[1] The term "bargain sale" means a transfer of property which is in part a sale or exchange of the property and in part a charitable contribution, as defined in sec. 170(c), of the property. Sec. 1.170A-4(c)(2)(iii), Income Tax Regs.

170(b)(1)(C)(iii) to apply section 170(e)(1)(B) requires the *entire property* to be taken into account, as provided in section 1.1011-2(a)(1), Income Tax Regs., in determining the amount of the reduction required under section 170(e)(1)(B). As I see the case, there are two separate steps involving reductions under section 170(e)(1)(B)—one involving section 1.1011-2(a)(1), Income Tax Regs., and one not involving it. As explained below, I think that the reduction required under section 170(e)(1)(B) resulting from an election by the taxpayer under section 170(b)(1)(C)(iii) has no applicability to section 1.1011-2(a)(1), Income Tax Regs. Consequently, I reach the same result that the majority reaches without addressing the validity of any regulation.

In a bargain sale to a charitable organization, part of the transaction is treated as a sale and part is treated as a charitable contribution. Generally, the charitable contribution is the difference between the fair market value of the property at the time of the sale and the amount realized. However, prior to calculating either the amount of gain on the sale or the amount of the deduction allowed under section 170, an initial determination is required under section 1011(b) and section 1.1011-2(a)(1), Income Tax Regs., to decide whether or not basis is to be allocated. This is sometimes called the "allowability test," and if the bargain sale does not pass this initial test, no charitable contribution is allowable and all of the basis remains available to reduce the amount of taxable gain on the sale.[2]

Section 1011(b) provides that:

> SEC. 1011(b). BARGAIN SALE TO A CHARITABLE ORGANIZATION.—If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

Section 1.1011-2(a)(1), Income Tax Regs., is a specific regulation pertaining only to bargain sales to charitable organizations. This regulation determines whether or not the adjusted basis must be allocated between the property that was sold and the property that was contributed. If no charitable contributions deduction is *allowable*, the adjusted basis of the property does not have to be allocated, and the entire adjusted basis is used in determining the amount of gain on the sale. However, if it is determined under this regulation that the adjusted basis must be allocated, i.e., if a charitable contributions deduction is allowable, then the amount of gain is determined under section 1011(b) and section 1.1011-2(b), Income Tax Regs. The amount allowed or allowable for the charitable contribution (fair market value - amount realized) is then computed under section 170 and the regulations thereunder in the same manner as though the contribution was an outright gift to a charitable organization. This computation will then be made, in my opinion, without going back to section 1.1011-2(a)(1), Income Tax Regs.

---

[2] See Weber & Stevenson, "Charitable Bargain Sales and The Allowability Test—A Tax Trap," 56 Taxes 101 (February 1978).

Pursuant to section 1.1011-2(a)(1), Income Tax Regs., the adjusted basis of the property must be allocated under section 1011(b) and section 1.1011-2(b), Income Tax Regs., *only if* after applying the provisions of section 170, including the percentage limitations of section 170(b),[3] a deduction is allowable under section 170. In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year "for such purposes" (to determine whether or not the adjusted basis must be allocated pursuant to section 1011(b) and the regulations thereunder), section 170 is to be applied without regard to this regulation and the amount by which the contribution must be reduced under section 170(e)(1) is the amount determined as if the *entire property* had been sold by the donor at its fair market value at the time of the sale or exchange. In other words, the adjusted basis must be allocated only if the charitable contribution (fair market value - amount realized) is greater than the reductions required under section 170(e)(1) determined by applying such section to the entire property. After satisfying this initial allowability test and determining that the adjusted basis of the property must be allocated, the taxpayer is no longer concerned with section 1.1011-2(a)(1), Income Tax Regs., and that regulation has no further applicability.

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[3] Sec. 1.1011-2(a)(2), Income Tax Regs., provides that the basis of the property must be apportioned in the year of the bargain sale if the sale or exchange gives rise to a charitable contribution that is carried over to a subsequent taxable year, whether or not such contribution is allowable as a deduction under sec. 170 in such subsequent taxable year. Since both sec. 170(b)(1)(A) and sec. 170(b)(1)(C) allow carryovers for contributions in excess of the percentage limitations contained therein, the reference to the percentage limitations of sec. 170(b) contained in sec. 1.1011-2(a)(1), Income Tax Regs., was intended to apply with respect to bargain sales made to organizations described in sec. 170(b)(1)(B). See, i.e., sec. 1.1011-2(c), example *(3)*, Income Tax Regs. However, since the Tax Reform Act of 1984, inter alia, extended the applicability of the 5-year carryover deduction under sec. 170(d) to excess contributions by individuals made to sec. 170(b)(1)(B) organizations, it is doubtful whether, under the present law, the percentage limitations of sec. 170(b) would preclude the allocation of basis under sec. 1.1011-2(a)(1), Income Tax Regs., with respect to bargain sales to any charitable organization. See generally Tax Reform Act of 1984, Pub. L. 98-369, sec. 301, 98 Stat. 777.

The majority has accepted the parties' litigating position that the election by petitioners under section 170(b)(1)(C)(iii) requires that the contribution portion of the bargain sale must be reduced under section 170(e)(1)(B) by taking into account the long-term capital gain attributable to the *entire property* as required by section 1.1011-2(a)(1), Income Tax Regs. I do not see the connection. I think the allowability test in which the *entire property* is considered is an earlier, preliminary test which petitioners have satisfied and that the reductions under section 170(e)(1)(B) pursuant to their election comes at a later stage and involves only the contributed portion of the property. In other words, the reduction contemplated by section 170(e)(1)(B) pursuant to petitioners' election requires only that portion of the long-term capital gain attributable to the contributed property be taken into account. While the statute and regulations are complex, a logical tracking of the Code and regulations supports my view. The method for computing the amount of long-term capital gain attributable to the contributed property is clearly set forth in section 1.170A-4(c)(3), Income Tax Regs. Indeed, an analysis of section 170(b)(1)(C) supports my interpretation.

Generally, charitable contributions to organizations described in section 170(b)(1)(A) ("50 percent charities") are allowed in any taxable year to the extent that the aggregate of such contributions does not exceed 50 percent of the taxpayer's contribution base[4] (adjusted gross income) for such year. However, an additional limitation is provided in section 170(b)(1)(C) with respect to contributions of certain capital gain property. Section 170(b)(1)(C) provides:

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[4] The term "contribution base" means adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under sec. 172). Sec. 170(b)(1)(E).

> (C) SPECIAL LIMITATION WITH RESPECT TO CONTRIBUTIONS OF CERTAIN CAPITAL GAIN PROPERTY.—
>
> (i) In the case of charitable contributions of capital gain property to which subsection (e)(1)(B) does not apply, the total amount of contributions of such property which may be taken into account under subsection (a) for any taxable year shall not exceed 30 percent of the taxpayer's contribution base for such year. For purposes of this subsection, contributions of capital gain property to which this paragraph applies shall be taken into account after all other charitable contributions.
>
> (ii) If charitable contributions described in subparagraph (A) of capital gain property to which clause (i) applies exceeds 30 percent of the taxpayer's contribution base for any taxable year, such excess shall be treated, in a manner consistent with the rules of subsection (d)(1), as a charitable contribution of capital gain property to which clause (i) applies in each of the 5 succeeding taxable years in order of time.
>
> (iii) At the election of the taxpayer (made at such time and in such manner as the Secretary prescribes by regulations), subsection (e)(1) shall apply to all contributions of capital gain property (to which subsection (e)(1)(B) does not otherwise apply) made by the taxpayer during the taxable year. If such an election is made, clauses (i) and (ii) shall not apply to contributions of capital gain property made during the taxable year, and, in applying subsection (d)(1) for such taxable year with respect to contributions of capital gain property made in any prior contribution year for which an election was not made under this clause, such contributions shall be reduced as if subsection (e)(1) had applied to such contributions in the year in which made.
>
> (iv) For purposes of this subparagraph, the term "capital gain property" means, with respect to any contribution, any capital asset the sale of which at its fair market value at the time of the contribution would have resulted in gain which would have been long-term capital gain. For purposes of the preceding sentence, any property which is property used in the trade or business (as defined in section 1231(b)) shall be treated as a capital asset.

Thus, section 170(b)(1)(C)(i) limits the total amount of contributions of capital gain property *to which subsection (e)(1)(B)* does not apply that may be taken into account each year to 30 percent of the taxpayer's contribution base (adjusted gross income). Section 170(b)(1)(C)(ii) provides that contributions of capital gain property exceeding that 30-percent limitation are carried over to subsequent years as contributions of capital gain property in a manner consistent with section 170(d).

However, in lieu of accepting this 30-percent limitation for contributions of capital gain property, a taxpayer may make an election under section 170(b)(1)(C)(iii) to apply section 170(e)(1) to all contributions of capital gain property (*to which subsection (e)(1)(B) does not otherwise apply*) made by the taxpayer during the taxable year.[5] If the election is made, the taxpayer must reduce the amount of the charitable contributions deduction otherwise allowable under section 170(b)(1)(C) by 50 percent of the gain that would have been long-term capital gain if the contributed property had been sold by the taxpayer at its fair market value determined at the time of such contribution.[6] The effect of the election is twofold: First, the election removes the otherwise allowable charitable contribution from the 30-percent limitation under section 170(b)(1)(C) and removes the capital gain property taint from the contribution.[7]

With respect to a bargain sale transaction, to accept the position that an election under section 170(b)(1)(C)(iii) requires the application of section 170(e)(1)(B) in accordance with section 1.1011-2(a)(1), Income Tax Regs., is simply, in my opinion, an erroneous application of the statute and the regulations. Both section 170(b)(1)(C)(iii) and section 1011(b) (and section 1.1011-2(a)(1), Income Tax Regs.) require reductions under section 170(e)(1). However, when interpreted and applied in the proper sequence within the entire statutory and regulatory framework, these two reductions operate in different spheres and are, in my opinion, mutually exclusive. I will demonstrate below what I believe to be the proper sequence and proper application of the statute and regulations.

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[5] In addition, the election may be made with respect to contributions of 30-percent capital gain property carried over to the taxable year even though the individual has not made any contribution of 30-percent capital gain property in such year. Sec. 1.170A-8(d)(2)(i)(*a*), Income Tax Regs. Note that the reference in this regulation to the election under sec. 170(b)(1)(iii) bears the old numbering of what is now sec. 170(b)(1)(C)(iii).

[6] It should be emphasized that an election under sec. 170(b)(1)(C)(iii) applies to all contributions of capital gain property *to which subsec. (e)(1)(B) does not otherwise apply* made during the year of the election. In addition, in applying the carryover provisions of sec.170(d) for the year of the election with respect to contributions of capital gain property made in any prior contribution year for which an election was not made, such contributions shall be reduced as if subsec. (e)(1) had applied to such contributions in the year in which made. Sec. 170(b)(1)(C)(iii) (last sentence).

[7] Removing the capital gain property taint from the contribution means that after applying sec. 170(e)(1)(B) as required by the election, clauses (i) and (ii) of sec. 170(b)(1)(C) are no longer applicable to contributions of capital gain property made during the taxable year. In other words, these contributions are then treated as contributions subject to the 50-percent limitation under sec. 170(b)(1)(A), and any amount in excess of this 50-percent limitation is carried over to subsequent years under sec. 170(d) as a sec. 170(b)(1)(A) contribution rather than as a sec. 170(b)(1)(C) contribution.

In a bargain sale transaction, section 170(e)(1) is applied under section 1.1011-2(a)(1), Income Tax Regs., to reduce the amount of the charitable contribution (fair market value - amount realized). The purpose of this initial application is to determine whether or not any charitable contributions deduction is allowable so that the basis of the property must be apportioned as provided in section 1011(b) and section 1.1011-2(b), Income Tax Regs. This is what is referred to above as the allowability test for the particular piece of property. Indeed, section 1.1011-2(a)(1), Income Tax Regs., by clear and unambiguous language specifically limits the application of section 170(e)(1) *for such purposes.* After this initial allowability determination has been made for the particular piece of property, section 1.1011-2(a)(1), Income Tax Regs., has no further applicability. In contrast, the reductions contemplated by section 170(e)(1)(B) pursuant to an election under section 170(b)(1)(C)(iii) apply to all contributions of capital gain property made during the taxable year. The position advanced by the parties as their litigating position and accepted by the majority necessitates a different treatment for contributions of capital gain property to which the election applies depending on whether such contributions were outright gifts or were made in connection with a bargain sale. I do not think that the election under section 170(b)(1)(C)(iii) was ever intended to draw such a distinction. Indeed, in the absence of an election, the amount of the contribution of capital gain property that is not otherwise subject to section 170(e)(1)(B) (and the only capital gain property to which an election could apply) is fixed and ascertained and is otherwise allowable under section 170(b)(1)(C) subject only to the percentage limitations contained therein. The interpretation accepted by the majority requires a quantum leap backward from section 170(b)(1)(C)(iii) back to section 1.1011-2(a)(1), Income Tax Regs., which I do not think is mandated either by the statute or the regulations. Having once satisfied section 1011(b) and section 1.1011-2(a)(1), Income Tax Regs., in the initial determination that some charitable contribution is allowable and that basis must be allocated, there is no need to return to section 1.1011-2(a)(1). I think the election under section 170(b)(1)(C)(iii) requires the application of section 170(e)(1)(B) computed under section 1.170A-4(c)(2) and (3), Income Tax Regs., and not under section 1011-2(a)(1), Income Tax Regs. Thus only the property contributed in the bargain sale is taken into account in that computation. Accordingly, I would analyze the instant case in the following manner.

Petitioners in the instant case sold capital gain property to a section 170(b)(1)(A) organization for the amount of $941,684. The fair market value at the time of the sale was $1,106,478, resulting in a charitable contribution of $164,794. The taxpayer's basis in the property was $654,632 that reflected the potential recapture of depreciation in the amount of $43,392. However, since neither the majority opinion nor the parties' briefs otherwise indicate, it is assumed that no portion of this depreciation will be treated as ordinary income on disposition of the property.

My analysis begins with section 1.1011-2(a)(1), Income Tax Regs., since the transaction was a bargain sale to a charitable organization. Under section 1.1011-2(a)(1), Income Tax Regs., it must be determined whether or not any charitable contributions deduction is *allowable* under section 170. If a deduction is allowable under section 170, *then* the basis of the property must be allocated between the sale portion and the contributed portion of the bargain sale. In making this initial determination, the contribution of property must be reduced under section 170(e)(1), determined *as if* the entire property had been sold by the donor at its fair market value at the time of the sale. This is the mandatory reduction under section 170(e)(1). The taxpayer made a charitable contribution in the amount of $164,794 (1,106,478 fair market value - 941,684 amount realized). If the property had been sold at its fair market value at the time of its contribution, $451,846 of gain would have been realized. However, since no part of this gain would have been ordinary income, no mandatory reduction is required under section 170(e)(1)(A). Moreover, at this stage, no mandatory reduction is made under section 170(e)(1)(B) since that section does not otherwise apply.[8] Accordingly, after applying section 1.1011-2(a)(1), Income Tax Regs., a charitable contributions deduction in the amount of $164,794 is allowable under section 170 subject only to the percentage limitations of section 170(b), and the basis of the property must be apportioned. At this point, section 1.1011-2(a)(1), Income Tax Regs., has no further applicability and the provision in regard to the gain on the *entire property* has served its limited purpose. Petitioners have passed this initial allowability test, and basis of the particular property must now be allocated.

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[8] Sec. 170(e)(1)(B) does not apply because (1) any part of this contribution that consisted of tangible personal property is not used by the donee in a manner unrelated to the purpose or function constituting the basis for its exemption under sec. 501, and (2) the donee was not a

Pursuant to section 1011(b) and section 1.1011-2(b), Income Tax Regs., petitioners have an adjusted basis of $552,133 for the part of the property constituting the sale (adjusted basis × amount realized/fair market value of entire property) (654,632 × 941,684/1,106,478), resulting in a total gain of $384,551 (941,684 – 557,133), all of which is long-term capital gain. Under section 1.170A-4(c)(2)(i), Income Tax Regs., petitioners' adjusted basis for the property contributed is $97,498 (adjusted basis × fair market value of contributed property/fair market value of entire property) (654,632 × 164,794/1,106,478). Basis having now been allocated, the next step is to compute the amount of the charitable contributions deduction to be allowed.

The charitable contribution of $164,794 (fair market value – amount realized) is now treated essentially in the same manner as an outright gift of capital gain property to an organization described in section 170(b)(1)(A). Accordingly, the fair market value of the contributed property must be reduced by the amounts required under section 170(e)(1). If the contributed property had been sold at its fair market value, the taxpayer would have realized a total gain of $67,296 (164,794 – 97,498) all of which would have been long-term capital gain. Sec. 1.170A-4(c)(3), Income Tax Regs. Since no part of this gain attributable to the contributed property would have been ordinary income, no reduction is required under section 170(e)(1)(A). Moreover, no reduction is necessary under the express language of section 170(e)(1)(B), since that section does not otherwise apply. At this stage, petitioners are otherwise allowed a

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private foundation as defined in sec. 509(a) other than a private foundation described in subsec. (b)(1)(D).

charitable contributions deduction of $164,794 subject to the 30-percent limitation under section 170(b)(1)(C). However, petitioners have elected to have section 170(e)(1) apply to all of their contributions of capital gain property made in the year 1977, and the only contribution of capital gain property is this amount of $164,794.

Accordingly, the amount of $164,794 is reduced under section 170(e)(1)(B) by 50 percent of the gain that would have been long-term capital gain if the contributed property had been sold at its fair market value at the time of the contribution. However, at this stage we do not go back to section 1.1011-2(a)(1), Income Tax Regs., because basis has already been allocated. Thus, the $164,794 is reduced by the amount of $33,648 (50 percent of 67,296) (451,846 × 164,794/1,106,478) (long-term capital gain × fair market value of contributed property/fair market value of entire property). This gives petitioners a deduction in the amount of $131,146 for the contributed portion of the bargain sale, subject to the percentage limitations of section 170(b)(1)(A).[9] This charitable contributions deduction can be carried over from the year of the bargain sale (1977) to the years before the Court (1978 and 1979). This would also mean that an adjustment would have to be made to the sale portion since respondent in the statutory notice of deficiency allocated all of the basis to the sale portion, thus decreasing the amount of petitioners' taxable gain.

I would hold for petitioners by applying the pertinent statutory and regulatory provisions in the sequence indicated above, thus pretermitting any determination of the validity of the regulations. Accordingly, while I agree with Judge Whitaker's views, I concur with the majority solely as to the result the majority reached. However, since the majority has chosen to invalidate the regulations, I join in Judge Whitaker's dissent.

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[9] While I have discussed what I call "the parties' litigating position" (and the basic premise of the majority opinion), I think my position is the same as petitioners' alternative argument which is alluded to but not well articulated in petitioners' brief. I believe my position was also anticipated in an early article discussing what was then the proposed regulations under the 1969 Tax Reform Act. See Whitaker, "Dealing with Outright Gifts to Charity in Kind," 30th Annual N.Y.U. Institute 45, 64-73 (1972).

WHITAKER, *J.*, agrees with this concurring and dissenting opinion.

WHITAKER, *J.* concurring and dissenting: I agree with Judge Parker's well-reasoned concurrence. The application of the statute and the regulations which she advocates is reasonable, well justified under the ambiguous statute here involved, and responds to our obligation to so interpret regulations as to uphold their validity. See *United Telecommunications, Inc. v. Commissioner*, 589 F.2d 1383, 1390 (10th Cir. 1978); *Miller v. Commissioner*, 84 T.C. 827, 845 (1985), on appeal (10th Cir., Nov. 20, 1985). However, the majority has apparently concluded that Judge Parker's analysis is incorrect. Thus, without, in my judgment, an adequate basis therefor, the Court invalidates these long-standing regulations. I must respectfully dissent from the majority's reasoning. Were it necessary to reach the opposite result in order to avoid invalidation of the regulations, I believe we should do so.

When called upon to interpret respondent's regulations, we have been charged by the U.S. Supreme Court time and again to refrain from substituting our judgment as to reasonableness for that of the Secretary. See, e.g., *United States v. Correll*, 389 U.S. 299 (1967); *Bingler v. Johnson*, 394 U.S. 741 (1969); *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472 (1979). The majority recognizes that the congressional intent is far from clear, that the regulations were issued "soon after enactment of the statutory provisions" (specifically in 1972) and that Congress has revisited this area on a number of occasions without any adverse comment with respect to the regulations. I have no disagreement with the majority's enunciation of the proper standard to apply; I simply disagree that the majority has correctly applied that standard.

In *National Muffler Dealers Association, Inc. v. United States*, *supra* at 477, Justice Blackmun said:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its

> purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute. [Citations omitted.]

The majority's interpretation may well be a more reasonable interpretation of the statute than respondent's, but that is immaterial. In my judgment, since the majority declines to accept Judge Parker's analysis, the Court should exercise judicial restraint and look to Congress for clarification of the statute.

PARKER, *J.*, agrees with this concurring and dissenting opinion.

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[1] Termination of recall Aug. 18, 1986.

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COOPERATIVES

Income From Interest and Barge Rents—Patronage or Nonpatronage Source—Nonexempt Agricultural Cooperative.—Where petitioner, nonexempt agricultural cooperative principally engaged in marketing its patrons' grains, derived certain income during its taxable year beginning June 1, 1979, and ending Feb. 29, 1980, from interest on short-term loans and from rentals of its two river barges, and Commissioner disallowed part of petitioner's patronage dividend exclusion under sec. 1382(b) on ground that it was not attributable to patronage sources, Court determined, on facts, interest income petitioner received from purchase of short-term debt instruments and rentals from barges derived from "business done with or for" its patrons within meaning of sec. 1388(a)(1), since petitioner's money management activities were inseparably intertwined with overall conduct of its cooperative enterprise, and leasing of its barges was integral part of its overall cooperative activity in moving its patrons' grain to market. *St. Louis Bank for Cooperatives v. United States*, 624 F.2d 1041 (Ct. Cl.), and *Cotter & Co. v. United States*, 765 F.2d 102 (Fed. Cir.), construed and followed. ***Illinois Grain Corp. v. Commissioner*** . . 435

CORPORATIONS

See **DIVIDENDS.**

CREDITS AND EXEMPTIONS

Investment Tax Credit and Depreciation—Addition to Refrigerated Storage Facility—Not Tangible Personal Property and Not Property in Nature of Machinery.—Where in 1976, petitioner placed in service an addition to its refrigerated facility for storage of frozen food products, and addition comprised a truck loading platform, a rail loading platform, and a refrigerated area, Court determined (1) costs of platforms were not eligible for investment tax credit under sec. 48(a)(1)(A) and regs. 1.48-1(c) and 1.48-1(e), since platforms constituted "buildings"; (2) costs relating to refrigerated area of addition were not eligible for credit other than as allowed by Commissioner, since refrigerated portion was not building for investment tax credit purposes, and neither structural elements nor refrigerated area as whole constituted "property which is in the nature of machinery" under reg. 1.48-1(c) (*Weirick v. Commissioner*, 62 T.C. 446, distinguished); and (3) since addition was not tangible personal property under reg. 1.48-1(c), petitioner could neither depreciate addition using 200-percent declining balance method of sec. 167(b)(2), but under sec. 167(j)(i)(B) was limited to 150 percent of amount allowable under straight line method of depreciation, nor could it depreciate addition using 8-year useful life. ***Munford, Inc. v. Commissioner*** 436

Rehabilitation Investment Credit—Accelerated Cost Recovery System—Failure To Elect Straight-Line Depreciation Method.—Where in 1973, petitioners purchased old factory building which

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CREDITS AND EXEMPTIONS—continued
they placed in service and sometime thereafter leased to manufacturing company; in 1982, they completed and placed in service improvements, but did not account for depreciation of improvements on their return; and on amended return they depreciated improvements using accelerated method in table in sec. 168(b)(1) and "applicable percentage" for first year of 5-year recovery period, and claimed 20-percent rehabilitation credit under sec. 38, Court determined petitioners did not qualify for rehabilitation credit claimed, since under secs. 46(a)(2)(A)(iv) and 46(a)(2)(F), credit against tax is allowed for "qualified rehabilitation expenditures," which as defined in sec. 48(g)(2)(B)(i) do not include "expenditures with respect to which an election has not been made under sec. 168(b)(3) (to use the straight-line method of depreciation)"; under sec. 168(f)(4)(B)(i), election must "be made on the taxpayer's return"; and petitioners did not make required straight-line depreciation election, even assuming that the amended return could be taken into account. *DeMarco v. Commissioner* 518

DEDUCTIONS

Intangible Drilling Costs—Off-shore Oil and Gas Drilling Platforms—Salvage Value.—Where in 1974-75, petitioner corporation elected to deduct on its consolidated income tax returns, as intangible drilling costs (IDC) under sec. 263(c), certain design and construction costs for self-contained offshore drilling and production platforms that were designed for estimated 20-year useful lives with no salvage value, Court determined costs incurred were deductible as IDC under reg. 1.612-4, since they were not incurred in acquisition of tangible property ordinarily considered to have salvage value. *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349, applied. *Gulf Oil Corp. v. Commissioner* 324

DEPRECIATION
See CREDITS AND EXEMPTIONS.

DIVIDENDS

Constructive—Controlled Foreign Corporations—Retroactive Change in Charter Hire Rates, Sale of Tanker, and Sec. 956 Applicability to Payable Balances.—Where petitioner corporation was engaged directly and through its foreign subsidiaries in world-wide exploration, development, etc., of petroleum products, Court determined (1) petitioner received constructive dividends (a) as result of adjustment of charter hire rates between two foreign subsidiaries and (b) as result of diversion of profit from sale of tanker to foreign subsidiary, and (2) petitioner realized dividend income for 1974 from increase in balances payable to two subsidiaries in its centralized cash management accounting system, since payable balances constituted "an obligation of a United States person" within meaning of sec. 956(b)(1)(C), and increases represented earnings of controlled corporations invested in U.S.

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DIVIDENDS—continued

property at close of taxable year under secs. 951(a)(1)(B) and 956(a)(1). *Gulf Oil Corp. v. Commissioner* 548

ESTATES AND TRUSTS

Gross Estate—Stock of Closely Held Investment Companies—No Discount in Valuation for Lack of Marketability.—Where decedent died April 9, 1979, owning all stock of two investment companies which had assets consisting solely of cash and marketable securities, Court determined, on facts, date of death value of stock of each investment company to be included in gross estate under sec. 2031 was its net asset value reduced by cost of liquidation, and no discount for lack of marketability was appropriate, since any purchaser of decedent's 100% interest in investment companies would acquire unconditional control over, and access to, underlying cash and securities. Estate of Jephson v. Commissioner........... 297

EXEMPT ORGANIZATIONS

Domestic Fraternal Society—Qualification of Tax-Exempt Social Club as—National College Fraternity's Unrelated Business Taxable Income From Investments.—Where petitioner national college fraternity, which was tax-exempt social club under sec. 501(c)(7), received investment income in taxable year 1971, Court determined (1) in light of statutory provisions, legislative history, and facts, petitioner did not also qualify as domestic fraternal society under sec. 501(c)(10), so that petitioner's unrelated business taxable income included investment income under sec. 512(a)(3)(A); and (2) prohibition in reg. 1.501(c)(10)-1 on national college fraternities' obtaining their tax exemption under sec. 501(c)(10) was valid and reasonable interpretation of statutory provisions. *Zeta Beta Tau Fraternity, Inc. v. Commissioner* 421

GIFTS

Stock in Family Corporation Transferred to Trust Under "Estate Tax Freeze" Plan—Estate and Gift Tax Purposes—Discounted Cash-Flow Method.—Where in 1976 shareholders of newly reorganized, closely held company X transferred shares of voting and nonvoting common stock to certain long-term trusts under "estate tax freeze" plan, Court determined, for estate and gift tax purposes, fair market value of stock under discounted cash-flow method, but value was not affected by transfer of stock to trusts. *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir.), and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir.), applied. *Northern Trust Co. v. Commissioner*...................... 349

INCOME

Exclusion for Foreign Earned Income—Joint Employment Contract With Stock Option for H Only—Allocability to W of Stock Option Proceeds and Attribution to Year in Which Earned.—Where petitioners were employed abroad under joint employment

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INCOME—continued
contract, which provided stock option for petitioner H alone, Court determined (1) petitioners could not allocate any of gain from H's 1978 disposition of stock to W for purpose of computing her foreign earned income exclusion under sec. 911, since petitioners, who were free to structure provisions of contract as they wished and who abided by contract, were required to accept tax consequences of their structural choice (*Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149); and (2) petitioners were entitled to attribute H's stock option proceeds to 1977 gross income under attribution rule of sec. 911(c)(2) for limited purpose of computing foreign earned income exclusion for 1977 under sec. 911(a)(1) and (c)(1)(B). Groetzinger v. Commissioner 533

SMALL BUSINESS CORPORATIONS

Termination of Election—Membership in Affiliated Group—Exception for Acquisition of Inactive Corporation Not Applicable.—Where subch. S corporation X on June 18, 1977, acquired all stock of corporation Y, which was actively engaged in real estate construction business and was indebted to X and others; and X proceeded with Y's developments and cleared up Y's debts, operating Y until Y's dissolution on May 10, 1979, Court determined petitioner X's subch. S status was terminated for 1977 when it became member of affiliated group with Y, contrary to sec. 1371(a), and X's acquistion of Y could not be disregarded because Y did not satisfy requirements of sec. 1371(d) in 1977, so that X could no longer pass through its undistributed income, deductions, and investment credits to petitioner shareholders. ***Haley Brothers Construction Corp. v. Commissioner*** 498

UNITED STATES TAX COURT

Petitioners' Motion for Litigation Costs—Commissioner's Reliance on Proposed Regulation Subsequently Invalidated—Reasonableness.—Where Commissioner offered to concede case 3 months after expiration of appeal period in *Scott v. Commissioner*, 84 T.C. 683, in which proposed regulation on which instant deficiency was based was determined to be inconsistent with statute, and Court granted Commissioner's motion to dismiss and entered decision in favor of petitioners, which decision was vacated after petitioners moved for award of litigation costs, Court determined Commissioner was not liable for petitioners' litigation costs under sec. 7430, since advocacy of position embodied in proposed or final regulation is reasonable until regulation is overturned by a court, and for reasonable period thereafter. ***Mearkle v. Commissioner*** 527

VALUATION
See CONTRIBUTIONS, ESTATES AND TRUSTS, GIFTS, and PENALTIES.

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

VALUATION

[illegible]

REPORTS

OF THE

UNITED STATES TAX COURT

ESTATE OF LUCRETIA DAVIS JEPHSON, DECEASED; DAVID S. PLUME, DERMOND IVES, AND THE CHASE MANHATTAN BANK, N.A., COEXECUTORS, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 6563-83. Filed August 5, 1986.

Decedent owned all the stock of two investment companies on the date of her death. The assets of both companies consisted solely of cash and marketable securities. *Held*, the value of the stock of each investment company is its net asset value reduced by the cost of liquidation.

John Y. Taggart and *Myron G. Finley*, for the petitioner.
Jack Klinghoffer, for the respondent.

JACOBS, *Judge*: By statutory notice of deficiency, respondent determined a deficiency of $847,458.38 in estate tax due from the Estate of Lucretia Davis Jephson, deceased. In his amended answer, respondent claimed a $263,655.19 increased deficiency; thus the total amount in controversy is $1,111,113.57.

After concessions, the only matter left for determination is the value of all the outstanding stock of two investment companies, R.B. Davis Investment Co. and Davis Jephson Finance Co., owned by Lucretia Davis Jephson at her death.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of fact and attached exhibits are incorporated herein.

Lucretia Davis Jephson died on April 9, 1979; petitioner is her estate. Petitioner's address at the time the petition was filed was New York, New York.

Petitioner reported in a timely filed Federal estate tax return the decedent's stock ownership in two wholly owned corporations, R.B. Davis Investment Co. (R.B. Davis) and Davis Jephson Finance Co. (Jephson Finance). R.B. Davis and Jephson Finance were investment companies, the former with 4,997 shares outstanding and the latter with 20,000 outstanding shares. R.B. Davis, formed under the laws of New Jersey in 1905, manufactured baking powder until 1955, when its assets were sold; thereafter, it operated as a holding company. Jephson Finance was formed in Delaware in 1933, and has been a holding company since its inception. The assets of both corporations consisted primarily of unleveraged portfolios (managed by Chase Manhattan Bank) of marketable securities with readily ascertainable fair market values on April 9, 1979 (the valuation date), as follows:

R. B. DAVIS

Bonds

Face value	*Market value*
$30,000 N.Y. State 3.6% due 5/1/87	$22,839
20,000 N.Y. State 3.6% due 11/1/87	14,980
50,000 N.Y. State 3.6% due 11/1/85	30,865
70,000 Penna. State Gen. Oblig. 5.9% due 12/15/92	67,277
50,000 Suffolk County Gen. Oblig. 3/5% due 9/1/83	33,630
	169,591

Certificate of Deposit

	Market value
Continental Illinois Bank 9½% due 3/30/79 principal and accrued interest	$116,306

Common Stocks

Number of shares		*Market value*
1,800	Merck & Co.	$119,700

Number of shares		*Market value*
1,000	Schlumberger Ltd.	$106,563
6,286	Scudder Managed Reserves	53,042
500	Smithline Corp.	47,156
2,800	Standard Oil Co. of Indiana	177,450
8,000	Virginia Electric & Pwr. Co.	101,500
2,500	Yellow Freight Systems Inc.	51,562
3,500	Aluminum Co. America	190,313
1,500	AT&T	92,625
1,000	Avon Products	46,750
4,000	Carolina Power & Light	83,000
2,000	Caterpillar Tractor	116,750
800	Coca-Cola Co.	33,000
4,000	Continental Oil	137,250
1,000	Digital Equipment	55,812
800	E.I. DuPont & Co.	114,250
1,300	Eastman Kodak	84,013
4,000	Florida Power Corp.	122,500
2,500	General Electric	119,219
3,500	General Mills, Inc.	87,859
2,200	Houston Ind. Inc.	66,412
500	IBM	159,188
4,000	International Paper	186,250
2,500	Lowes' Co. Inc.	120,312
2,000	Mapco Inc.	62,250
1,000	McDonald's Corp.	42,125
		2,579,851
	Total bonds, certificate of deposit, and stocks	2,865,748

JEPHSON FINANCE

Bonds

Face value		*Market value*
$100,000	Baltimore Gen. Oblig. 4.1/4% due 10/15/85	$87,000
100,000	California Gen. Oblig. 3.1/2% due 7/1/81	94,390
50,000	Kentucky Gen. Oblig. 3.1/8% due 7/1/87	40,030
100,000	Los Angeles City Unified School 3.1/2% due 2/1/84	88,450
50,000	Mass. Bay Trans. Auth. 3.8% due 3/1/98	32,510
100,000	Milwaukee Met. Sewr. Dist. 33.4% due 2/1/83	89,980
100,000	Minn./St. Paul 3.7% due 1/1/85	87,240
50,000	Nassau County Gen. Oblig. 3.4% due 11/15/82	44,525
100,000	New Jersey Gen. Oblig. 3% due 3/1/85	82,960
50,000	NYS Gen. Oblig. 4% due 11/15/84	44,070
100,000	NYS Gen. Oblig. 4% due 11/15/86	83,760
70,000	Oakdale CA Sewr. Dist. 3.05% due 7/1/2004	36,000
75,000	Oregon Gen. Oblig. 3.3/4% due 8/15/79	74,460
175,000	Penna. Gen. Auth. 4.4% due 7/15/83	160,860
(Unspecified)	Texas Gen. Oblig. 3% due 8/1/86	20,093
		1,066,328

Certificate of Deposit

	Market value
Continental Ill. Bank 9½% due 3/30/79 principal and accrued interest	$536,411

Common Stocks

Number of shares		*Market value*
1,500	McDonald's Corp.	$63,188
1,200	Merck & Co., Inc.	79,800
2,500	Monsanto Co.	131,094
2,500	J. P. Morgan & Co.	115,469
2,000	J. C. Penny Inc.	58,880
1,000	Proctor & Gamble	80,750
2,000	Revlon Inc.	99,000
3,000	Roadway Express	84,825
9,475	Scudder Managed Reserves (Mutual Fund)	94,653
2,000	Standard Oil of Ohio	100,750
5,000	Texas Utilities	96,562
2,500	Union Camp Corp.	126,250
1,500	Union Pacific Corp.	94,781
3,000	American Express Co.	92,250
4,000	AT&T	247,000
4,000	Atlantic Richfield	259,250
1,500	American Natural Resources Co.	62,231
3,000	Bank America Corp.	76,125
5,000	Carolina Power & Light Co.	103,750
4,000	Chase Manhattan Corp.	129,750
2,500	Chubb Corp.	98,125
3,000	Citicorp	69,750
4,000	Colgate-Palmolive Co.	69,750
2,000	Continental Oil Co.	68,625
2,500	Diamond Int'l.	92,500
2,000	Digital Equipment Corp.	111,625
6,000	Dow Chemical	170,250
2,000	Dresser Ind.	89,250
2,000	Eastman Kodak	129,250
2,500	Eaton Corp.	94,219
4,000	Exxon	214,250
4,000	Florida Power & Light	110,000
2,000	General Electric	95,375
2,200	Houston Ind. Inc.	66,412
1,895	IBM	603,321
7,000	IT&T	201,250
4,500	Johnson & Johnson	314,719
3,000	Lowe's Co. Inc.	144,375
2,000	Macy & Co.	71,250
2,500	Marathon Oil	168,437
		5,179,091
	Total bonds, certificate of deposit, and stocks	6,781,830

The book and market values of the assets, liabilities, and shareholder's equity of each company on the valuation date were as follows:

R. B. Davis

Book and Market Value

April 9, 1979

	Book value	*Market value*
SECURITIES:		
Bonds	$336,000	$169,591
Stocks	2,271,073	2,579,851
	2,607,073	2,749,442
CASH ACCOUNTS:		
Certificate of deposit and accrued interest	116,306	116,306
Investment advisory -principal	326	326
-income	3,902	3,902
Checking	94,996	94,996
Accrued income	3,079	8,136
Total assets	2,825,682	2,973,108
Less: Accounts payable	1,650	1,650
NET WORTH	2,824,032	2,971,458
Common stock	499,700	499,700
Paid in surplus	444	444
Retained earnings	2,323,888	2,323,888
Appreciation - market value	- - -	147,426
SHAREHOLDER'S EQUITY	2,824,032	2,971,458
Per share (4,997 shares)	565.15	594.65

Jephson Finance

Book and Market Value

April 9, 1979

	Book value	*Market value*
SECURITIES		
Bonds	$1,694,963	$1,066,327
Stocks	3,964,687	5,179,091
Total	5,659,650	6,245,418
CASH ACCOUNTS:		
Certificate of deposit and accrued interest	536,411	536,411
Investment advisory -principal	916	916
-income	15,733	15,733
Checking	231,251	231,251
Prepaid Federal taxes	3,731	3,731
Accrued income	- - -	24,072
Total assets	6,447,692	7,057,532
Less: Accounts payable	- - -	- - -
NET WORTH	6,447,692	7,057,532
Common stock	2,000,000	2,000,000
Paid in surplus	2,778	2,778

	Book value	*Market value*
Retained earnings	$4,444,914	$4,444,914
Appreciation - market value	---	609,840
SHAREHOLDER'S EQUITY	6,447,692	7,057,532
Per share (20,000 shares)	322.38	352.88

The cost of liquidating R.B. Davis on the valuation date would have been $48,672.30. The cost of liquidating Jephson Finance on the valuation date would have been $46,164.13.

Petitioner valued for estate tax purposes the decedent's interests in R.B. Davis and Jephson Finance by applying discounts of 28 percent and 31.3 percent, respectively, to their net asset values, to reflect the lack of marketability of the stock of each company. The amount of the discount was determined by reference to the discount from net asset value of 10 publicly traded closed-end investment funds which had portfolio profiles similar to those of the two companies involved herein.

Respondent claims that the values of the companies are their net asset values, less liquidation expenses. Respondent argues that no discount for lack of marketability is appropriate because any purchaser of decedent's 100-percent interest in the investment companies would acquire unconditional control over, and access to, their underlying cash and securities. Respondent further contends that direct ownership of the cash and securities could be obtained in a tax-free transaction pursuant to section 337.[1]

ULTIMATE FINDINGS OF FACT

(1) On April 9, 1979, the stock of R.B. Davis Investment Co. had a value of $2,922,786 (i.e., its net asset value, less liquidation expenses).

(2) On April 9, 1979, the stock of Jephson Finance Co. had a value of $7,011,368 (i.e., its net asset value, less liquidation expenses).

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect on the date of decedent's death.

OPINION

Section 2031(a) mandates inclusion in the gross estate of the value of all property owned by a decedent at the time of death. For estate tax purposes, in general, value means fair market value on the applicable valuation date.[2] Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Sec. 20.2031-1(b), Estate Tax Regs.

Valuing stock of a closely held corporation is a factual determination for which there is no talismanic formula. A weighing of all relevant facts and circumstances is required. In determining such value, section 2031(b) requires that consideration be given, in addition to all relevant factors, to the price of stock of corporations engaged in the same or similar line of business which are listed on an exchange.

After considering all relevant facts and circumstances, we find that the date of death values of R.B. Davis and Jephson Finance Co. are their respective net asset values, less the cost of liquidation. The factors that persuaded us in reaching this finding are: (l) All the assets of both investment companies were liquid assets, i.e., cash and marketable securities; (2) neither corporation had any liabilities which had to be seriously considered in valuing the companies; (3) the decedent's 100-percent ownership of both companies gave her (or her estate) the unqualified right to liquidate both companies at any time. In our opinion, neither the decedent nor her estate nor a hypothetical seller would have sold the stock of either company for less than that which could have been realized through liquidation. We further believe that a hypothetical purchaser would be willing to pay such an amount.[3]

We recognize that the value of an interest in an investment company is not always equal to its proportionate share of the company's net asset value. For example, we have applied a discount where a minority interest was being valued. *Harwood v. Commissioner*, 82 T.C. 239, 264-269 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979); *Estate of DeGuebriant v. Commissioner*, 14 T.C. 611 (1950), reversed on another issue sub nom. *Claflin v. Commissioner*, 186 F.2d 307 (2d Cir. 1951). We have also allowed a discount for the nonmarketability of an investment company's stock, particularly where its assets consist of real estate or other nonliquid assets. *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982). Here, however, there is neither a minority interest nor any nonliquid assets.

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[2] A decedent's gross estate is valued as of the date of death, unless the executor elects (pursuant to sec. 2032) the alternate valuation. Here, no such election was made.

[3] The hypothetical purchaser, by purchasing the companies, would save brokerage fees that otherwise would have to be paid to acquire approximately $9 million of marketable securities.

Petitioner does not argue that it is entitled to a minority interest discount, since it owns all of the stock of both companies. Nevertheless, petitioner indirectly seeks to obtain a minority interest discount by analogizing R.B. Davis and Jephson Finance to publicly traded closed-end investment companies. We agree that in many respects R.B. Davis and Jephson Finance are comparable to closed-end investment companies. Also, we recognize that stock in closed-end investment companies often sells for less than net asset value. However, an investor in a closed-end investment company has little or no say in the selection of the company's investment advisor or the company's portfolio and cannot easily force the liquidation of the company. Petitioner did not present any evidence of sales of controlling interests in closed-end investment companies. The sale of a controlling interest in a closed-end investment company might well command a premium, rather than be subject to discount. In any event, we find inapposite petitioner's comparison of the sale of 100-percent interests in R.B. Davis and Jephson Finance to sales of minority interests in publicly traded closed-end investment companies.

Petitioner next argues that a discount for nonmarketability is warranted. Petitioner contends that marketable securities and cash, when held in corporate solution, are not readily marketable. This argument ignores the fact that complete ownership of each corporation enables petitioner to obtain, at any time, direct ownership of the corporate assets either through a partial or complete liquidation or through a dividend in kind.

Lastly, petitioner argues that a purchaser of the stock of R.B. Davis and Jephson Finance would demand a discount for the existence of unknown liabilities. Only R.B. Davis was an operating company[4]— it manufactured baking powder prior to 1955. The potentially hazardous substance allegedly included in the baking powder manufactured by R.B. Davis is alum, which around 1905 was thought to be hazardous to health. Petitioner submitted no evidence that alum is hazardous to health or that any liability for its use was ever imposed on R.B. Davis or any other manufacturer of baking powder, or that any hazardous effects of alum had remained undetected for the 24 years which had elapsed between the date R.B. Davis ceased to manufacture baking powder and the date of decedent's death. In any event, any claim brought against R.B. Davis would probably have been time-barred. In short, we are not persuaded by this argument and believe that here no discount is warranted for unknown liabilities.

Respondent conceded that there should be a reduction for the transactional costs which the owner of R.B. Davis and Jephson Finance stock would incur in obtaining direct ownership of the corporate assets through a liquidation. We have accordingly taken these costs into account in valuing both companies.

To reflect the foregoing and the concessions of the parties,

Decision will be entered under Rule 155.

HAZEL DESKINS, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 4302-84. Filed August 11, 1986.

P disposed of coal by a contract entitled "Coal Lease" under which she will receive a tonnage royalty of $1 per ton of coal mined. However, P will not receive more than $4.3 million even if more than 4.3 million tons of coal are mined. Under the contract, P will receive an annual minimum royalty of $430,000 per year for 10 years. Any tonnage

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[4] As previously noted, Jephson Finance was at all times an investment company.

royalty P receives during a year is credited against the annual minimum royalty for the year. If the tonnage royalty due during a year exceeds the annual minimum royalty for the year, the excess is recouped against any annual minimum royalty paid in any prior year and any remaining excess is applied as a prepayment of any annual minimum royalty due in any future year. P will receive $4.3 million, no more and no less. No portion of the payments to be made under the contract is designated as interest. Petitioner has no reversionary interest in the coal so long as she receives the payments required by the contract. *Held*: Because P will receive tonnage and/or annual minimum royalties of $4.3 million, no more and no less, regardless of whether any coal is ever actually mined, P need not look to the extraction of the coal for the return of her capital, and, therefore, has not retained an economic interest in the coal. Thus, the payments she receives under the contract do not qualify for capital gain treatment under secs. 631(c) and 1231(b)(2), I.R.C. 1954. *Held, further*: Since sec. 631(c), I.R.C. 1954, does not apply, payments received under the contract are subject to the imputed interest rules of sec. 483, I.R.C. 1954. Thus, a portion of each such payment is ordinary interest income under secs. 483 and 61(a)(4), I.R.C. 1954, and only the balance is capital gain from P's sale of a capital asset.

John G. Rocovich, Jr., *Joseph L. Anthony*, and *John T. Arnold*, for the petitioner.

Edwina L. Wilson, for the respondent.

PARKER, *Judge*: Respondent determined a deficiency in petitioner's 1980 Federal income taxes in the amount of $54,469.32. The issues for decision are (1) whether under the contract petitioner retained an economic interest in the coal so that payments she receives for the disposition of the coal qualify for capital gain treatment under sections 631(c)[1] and 1231(b)(2), and (2) if section 631(c) does not apply, whether the payments she receives for the coal are subject to the imputed interest rules of section 483.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years pertinent to this case, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioner resided in Belfry, Kentucky, at the time she filed the petition in this case. Petitioner filed her 1980 Federal income tax return (Form 1040) with the Internal Revenue Service Center in Memphis, Tennessee.

Petitioner acquired legal title to two tracts of real property (the property) situated on the Fifty-Eight Mile Branch of Racoon Creek, a tributary of Johns Creek, in Pike County, Kentucky, by a deed from Troy T. Deskins dated June 24, 1964. Petitioner held the property for over 12 years prior to the transaction involved herein.

Wellmore Coal Corp. (Wellmore), through its parent corporation, United Coal Cos., obtained a Reserve Estimate (the estimate report) dated February 25, 1977, from Thompson & Litton, Inc., Professional Engineers, on certain seams of coal in the property. Included in the estimate report is a survey map of the property that shows the topography of the property and the coal seams therein. The estimate report concludes that there are 6.8 million tons of coal in place and 4.3 million tons of recoverable coal in the property.[2] The 4.3 million tons of recoverable coal in the property could easily be mined in 4 years.

On February 25, 1977, petitioner[3] and Wellmore entered into a contract (the contract) entitled "Coal Lease," the purpose of which was to dispose of coal in place in the property. The contract grants to Wellmore mining rights to all coal in, and complete and absolute surface rights over, the property. The contract remains in effect for such period of time necessary to mine the merchantable and recoverable coal. The contract states that the parties agree that there are 4.3 million tons of minable and merchantable coal in the property that can be recovered in a 10-year period.[4] The contract requires Wellmore to pay petitioner a tonnage royalty of $1 per ton mined, payable monthly not later than the 25th day of the month following the month the coal is mined. However, the contract provides that Wellmore's obligation to pay tonnage and/or annual minimum royalties to petitioner ceases after it pays her a total of $4.3 million, even if Wellmore mines more than 4.3 million tons of coal.[5] Thus, the maximum amount petitioner will receive under the contract is $4.3 million.

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[2] Coal "in place" is the total amount of coal that is in the ground. "Recoverable" coal is an estimate of the amount of coal that can actually be extracted from the property based on historical information and the engineer's experience. According to the estimate report, the percentage of recovery for deep mining varies from 50 to 75 percent. The estimate report uses a recovery percentage of roughly 63 percent.

[3] The contract is between Hazel Deskins Burke and Wellmore. Petitioner is the same person referred to in the contract as Hazel Deskins Burke.

Wellmore is obligated by the contract to pay petitioner an annual minimum royalty of $430,000 each year for 10 years, not later than the 25th day of the month following the end of each year. Thus, the minimum amount petitioner will receive is also $4.3 million. See note 5 *supra.*

Any tonnage royalty petitioner receives during a year is credited against the annual minimum royalty due for that year. If the tonnage royalty due during a year exceeds the annual minimum royalty for the year, Wellmore may recoup the excess against any annual minimum royalty paid during any prior years and may apply any remaining excess tonnage royalty as a prepayment of any annual minimum royalty due in any future year or years.[6] Tonnage royalties are payable as coal is mined so that if Wellmore mines 4.3 million tons of coal before the 10-year contract period expires, petitioner will receive the $4.3 million over the shorter period of time. Thus, under the contract, petitioner will receive tonnage and/or annual minimum royalties of $4.3 million, no more and no less, over 10 years or less, regardless of whether any coal is ever actually mined. See notes 4, 5, 6 *supra*.

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[4] The contract expressly states in the Duration provision that:

"Lessee firmly and absolutely agrees to produce such tonnage of coal during such 10-year term and/or pay the actual and/or minimum royalties herein provided for when and as they become due. The agreed recoverable tonnage is firm, absolute and not subject to change or alteration on any basis. The amount of minimum royalty to be paid is also firm, absolute and not subject to change on any basis. This lease shall be construed as a Coal Lease for production of an agreed tonnage of coal (the agreed tonnage of which is also absolute and not subject to change on any basis) with a commitment to mine and pay for the coal on the basis of the actual tonnage royalty and/or the minimum annual royalty during the term as herein provided."

[5] Specifically, the contract states in the Tonnage Royalty provision that:

"Once $4,300,000 has been paid by way of actual tonnage and/or annual minimum royalties as provided, all royalties shall cease and Lessor [sic] shall not be required to pay any further sums hereunder."

Similarly, in the Minimum Royalty provision, the contract states:

"The intention of the parties, in providing for the annual minimum royalty, is to insure that the Lessee [sic] shall actually receive by way of actual tonnage and/or annual minimum royalties, at least $430,000 per lease year, or a total of $4,300,000 over the entire ten (10) year period. Thereafter, there shall be no further minimum royalty and no covenant by Lessee to diligently mine."

[6] The following example illustrates the interplay of the contract's royalty and recoupment provisions. If Wellmore mines no coal during year one, it must still pay petitioner $430,000 that year as an annual minimum royalty. If Wellmore mines 1 million tons of coal during year two, it can "recoup" $430,000 of the $1 million tonnage royalty due against the annual

No portion of the payments to be made under the contract is designated as interest.

The contract states that "the economic interest in and to the coal in, on and under the [property] for income tax and all other purposes shall be deemed, construed and shall be in [Wellmore]." The contract contains a "diligent mining provision" that requires Wellmore to diligently mine the coal as expeditiously as possible using modern and efficient mining machinery, equipment, and methods, so as to mine the largest feasible tonnage in the shortest feasible time.[7] If Wellmore fails to make the payments required by the

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minimum royalty it paid for year one. Thus, Wellmore would have to *pay* $570,000 as tonnage royalty for year two ($1 million tonnage royalty due less $430,000 "recouped" annual minimum royalty paid for year one). If Wellmore mines no coal during year three, $140,000 of the tonnage royalty for year two ($570,000 tonnage royalty paid for year two less $430,000 annual minimum royalty for year two) is applied as a prepayment of the annual minimum royalty for year three, so that Wellmore would have to pay only an additional $290,000 ($430,000 annual minimum royalty due less $140,000 excess tonnage royalty paid for year two) as an annual minimum royalty for year three.

[7] Petitioner argues that the diligent mining provision of her contract was "extraordinarily stringent," that it somehow imposed a duty on Wellmore to mine and remove the coal and pay the royalties as expeditiously as possible in the shortest feasible time. The diligent mining provision of the contract states that:

> "Lessee covenants and agrees to forthwith enter upon such property, commence mining the coal thereon and to diligently mine the same as expeditiously as possible using modern and efficient mining machinery, equipment and methods, now known or as may be developed, so as to mine and produce the largest feasible tonnage of coal in the shortest feasible period of time."

As will be discussed further in the opinion below, the interplay of the maximum total sum of $4,300,000 and the full application of the annual minimum royalties against this total sum without any time limit (other than the 10-year period) does not serve to expedite mining. Moreover, the diligent mining provision is undercut by other provisions in the contract. See the Duration provision which states "Lessee firmly and absolutely agrees to produce such tonnage of coal during such 10-year term *and/or* pay the actual and/or minimum royalties herein provided for when and as they become due." (Emphasis added.) Thus, not even the 10-year period is absolute; only payment of $4.3 million is absolute. Furthermore, the Conduct of Mining Operations clause notes that Wellmore "is or may be conducting mining operations on lands owned by numerous Lessors" and will conduct its mining operations according to a plan that will take into consideration "the entire area proposed to be developed" by Wellmore. For all these reasons, we cannot find that the diligent mining provision was stringent or compelled any mining during the 10-year period or any other period.

contract, petitioner can accelerate the as yet unpaid annual minimum royalties ($4,300,000 less any actual tonnage and/or annual minimum royalties paid to such date), and unless Wellmore cures the default, the contract terminates and petitioner can retake possession of the property and all fixtures, machinery, equipment, and other property placed thereon by Wellmore, free and clear of any claim by Wellmore. If Wellmore makes the required payments ($4,300,000), petitioner has no reversionary interest in the coal and Wellmore retains the right to mine the coal after the 10-year contract period, free of any further royalty payment.

The contract is a typical coal lease in that it contains the essential provisions of a coal lease. It is atypical, however, in several respects. Most coal leases do not specify a maximum amount of royalties payable. In those coal leases that specify a maximum, the maximum and minimum amount of royalties payable are rarely equal, as they are in the instant contract. A maximum is usually stated only when the parties have a third-party estimate of the approximate tonnage of coal in place. The contract's recoupment provision is unusual in that it does not state a cutoff period after which tonnage royalties due cannot be recouped from previously paid or future annual minimum royalties. See notes 4, 5, 6 *supra*. The annual minimum royalties of $430,000 can be applied to reduce any tonnage royalties at any time during the 10-year period, and after payment of a total sum of $4,300,000 of annual minimum royalties and/or tonnage royalties, no further royalties are payable to petitioner. See notes 4, 5, 6 *supra*.

At the time the parties entered into the contract, the typical tonnage royalty for deep mine coal was about 8 percent of gross sales which amounted to about $2 per ton. The contract's $1 per ton royalty resulted from the parties' negotiations and reflected petitioner's willingness to accept a lower royalty in exchange for payments over a shorter period of time, 10 years rather than the usual 20 or 30 years for coal leases. Petitioner relied on the estimate of recoverable coal in negotiating the tonnage royalty.

Petitioner was represented by C. Kilmer Combs (Combs), an attorney, and Caleb B. Cooley (Cooley), a certified public accountant, during the negotiation of the contract. They advised petitioner to dispose of the coal in such a manner that she would receive the proceeds therefrom in a relatively short period of time. Petitioner instructed Combs and Cooley to negotiate and draft the contract so that she could obtain the most favorable tax consequences thereunder. She hoped to receive capital gain treatment on the entire proceeds.

To the date of the trial, Wellmore had not mined any coal from the property. Wellmore has not defaulted on its obligations under the contract, and its right to mine the coal has not expired, terminated, or been abandoned. Wellmore has paid petitioner the annual minimum royalty under the contract in the amount of $430,000 each year since 1978. Cooley has prepared petitioner's Federal income tax return each year since the date of the contract and has consistently treated the annual minimum royalties as long-term capital gain income from the sale of coal in place.[8]

During 1980, petitioner received an annual minimum royalty payment under the contract in the amount of $430,000. No coal was mined from the property during that year. On the Schedule D, Capital Gains and Losses, attached to her 1980 return, petitioner reported the $430,000 payment as long-term capital gain from the sale of coal in place. By statutory notice of deficiency dated November 23, 1983, respondent determined that $129,688.86 of the $430,000 payment was ordinary interest income under sections 483 and 61(a)(4), and adjusted petitioner's taxable income accordingly.

ULTIMATE FINDING OF FACT

Petitioner did not retain an economic interest in the coal.

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[8] Although the facts are not relevant or material to any issue in this case, the record further shows that Wellmore consistently treated the annual minimum royalties it paid petitioner as a deductible royalty expense (sec. 1.612-3(b)(1), Income Tax Regs.) until its return was audited by the Internal Revenue Service (the Service). At the appeals level, the Service determined that portions of Wellmore's payments to petitioner were deductible as imputed interest under secs. 483 and 163. The remaining portions were treated as annual installment payments to purchase coal reserves. The Service had audited petitioner's 1979 return and made no adjustments to her treatment of the annual minimum royalty she received that year.

OPINION

This case involves a "Coal Lease" contract under which petitioner will receive $4.3 million, no more and no less, regardless of the number of tons of coal mined or regardless of whether any coal is mined. The issue before the Court is whether the disposition of the coal comes within section 631(c), and therefore section 1231(b)(2), so that each payment received is a sale or exchange entitled to capital gain treatment, or whether the transaction was an outright sale of a capital asset subject to the imputed interest provisions of section 483. This turns on whether, under the contract, petitioner retained an economic interest in the coal.

Royalty income received under a lease granting rights to extract minerals in place is usually ordinary income. *Davis v. Commissioner*, 74 T.C. 881, 890 (1980), affd. 746 F.2d 357 (6th Cir. 1984). See *Burnet v. Harmel*, 287 U.S. 103 (1932). Generally, if the owner-lessor retains an economic interest in the minerals being mined, the transaction is a lease and not a "sale or exchange," the latter being a prerequisite to capital gain treatment under section 1222. *Davis v. Commissioner*, 74 T.C. at 890. See *Palmer v. Bender*, 287 U.S. 551 (1933); *Belknap v. United States*, 406 F.2d 737 (6th Cir. 1969).

However, to provide special relief to recipients of coal royalties, Congress enacted the predecessor of section 631(c). S. Rept. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 488. Section 631(c)[9] treats a disposal of coal as a *sale* if, inter alia, the disposal is "under any form of contract by virtue of which such owner retains an economic interest in such coal." Section 1231(b)(2)[10] treats section 631(c) coal as property used in the trade or business. Thus, gain or loss from the disposal (treated as a sale by section 631(c)) of such coal is characterized under section 1231(a). See sec. 1.1231-1(c)(3), Income Tax Regs. In short, taken together, sections 631(c) and 1231(b)(2) convert coal royalties that would otherwise be ordinary income into capital gain, if there is a gain, or into ordinary loss, if there is a loss. See *Davis v. Commissioner*, 74 T.C. at 891-892. If a disposal of coal qualifies for section 631(c) treatment, the date of disposal is deemed to be the date the coal is mined or the date the minimum royalty payments are received, and section 483 does not apply to the payments received. H. Rept. 749, 88th Cong., 1st Sess. (1963), 1964-1 C.B. (Part 2) 125, 198. See secs. 1.483-1(b)(1), 1.631-3(b)(1), and 1.631-3(c)(1), Income Tax Regs.

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[9] During 1980, sec. 631(c) provided in pertinent part as follows:

(c) DISPOSAL OF COAL OR DOMESTIC IRON ORE WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of coal (including lignite), or iron ore mined in the United States, held for more than 1 year before such disposal, by the owner thereof *under any form of contract by virtue of which such owner retains an economic interest in such coal* or iron ore, the difference between the amount realized from the disposal of such coal or iron ore and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal or iron ore. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore. * * * The date of disposal of such coal or iron ore shall be deemed to be the date such coal or iron ore is mined. * * * [Emphasis added.]

[10] Sec. 1231(b)(2) provides as follows:

As previously stated, for section 631(c) to apply, the owner must dispose of coal under a contract by which the owner *retains an economic interest* in the coal. A taxpayer has an economic interest in coal if he has (1) acquired by investment any interest in the coal in place, and (2) secured by any legal relationship income derived from the extraction of the coal to which he must look for a return of his capital.[11] *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 314 (1956), quoting *Palmer v. Bender*, 287 U.S. at 557; *Freede v. Commissioner*, 86 T.C. 340 (1986) (Court-reviewed), and cases cited therein.

In applying the economic interest test, we must consider economic realities, not legal abstractions. *Gulf Oil Corp. v. Commissioner*, 86 T.C. 115, 134 (1986). See *Commissioner v. Southwest Exploration Co.*, 350 U.S. at 315. Retention of an economic interest does not turn merely on the subtleties of draftsmanship, the formal attributes or descriptive terminology of an instrument, or local law. *Whitehead v. United States*, 555 F.2d 1290, 1292 (5th Cir. 1977), and cases cited therein; *Gitzinger v. United States*, 404 F.2d 191, 193 (6th

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(2) TIMBER, COAL, OR DOMESTIC IRON ORE.—Such term [property used in the trade or business] includes timber, coal, and iron ore with respect to which section 631 applies.

[11] This definition has been incorporated into the regulations. Sec. 1.611-1(b)(1), Income Tax Regs., provides as follows:

"An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. * * *"

Cir. 1968). We must view the entire transaction to determine its total effect. *Gulf Oil Corp. v. Commissioner*, 86 T.C. at 134. No one factor clearly indicates ownership of an economic interest in mineral in place. *Freede v. Commissioner*, 86 T.C. at 348. The determination depends on the totality of the facts of each case. *Ramey v. Commissioner*, 398 F.2d 478, 478-479 (6th Cir. 1968). See *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 606 (1946); *Lesher v. Commissioner*, 73 T.C. 340, 360 (1979), affd. on another issue 638 F.2d 64 (8th Cir. 1981).

The parties do not dispute that petitioner satisfies the first prong of the economic interest test. They disagree about the second prong—whether petitioner secured by any legal relationship income derived from extraction of the coal to which she must look for a return of her capital. This language has been interpreted to mean that the taxpayer must look *solely* to extraction of the mineral for the return of her capital. *Commissioner v. Southwest Exploration Co.*, 350 U.S. at 314; *O'Connor v. Commissioner*, 78 T.C. 1, 10-11 (1982). Respondent argues that here petitioner need not look *solely* to the extraction of the coal for a return of her capital because under the contract she will receive $4.3 million for 4.3 million tons of coal *regardless* of whether any coal is ever actually mined. Thus, respondent contends, petitioner did not retain an economic interest in the coal, and section 631(c) does not apply to the payments petitioner receives under the contract. Therefore, the contract is an installment sales agreement to which section 483 applies.

In making these arguments, respondent relies heavily upon *Muheim v. United States*, an unreported case (D. Ariz. 1973, 32 AFTR 2d 73-5920, 73-2 USTC par. 9726), affd. per curiam 524 F.2d 773 (9th Cir. 1975). There, the taxpayers entered into an agreement labeled "lease and option" whereby the taxpayers transferred exclusive possession of and the right to explore for minerals in 40 unpatented lode mining claims in Pima County, Arizona, for the term of the agreement. The transferee was obligated to pay the taxpayers annual minimum royalties and earned royalties once production began. Earned royalties were to be credited first against the fixed minimum royalty for the year and then against the fixed minimum royalty for the following year.

The agreement also gave the transferee an exclusive option to purchase the mining claims for a sum certain, all prior minimum and earned royalties to be applied toward the purchase price. The taxpayers conceded that the transaction was a sale of the mining claims, but argued against application of section 483, insisting that they retained an economic interest in the mines and that each fixed minimum payment represented a sale of only a fraction of their interest in the asset. The District Court held that the taxpayers had nothing that could be treated as a retained economic interest in the property and that the transaction was an installment sale subject to the imputed interest rules of section 483. *Muheim v. United States, supra*, 32 AFTR 2d at 73-5921, 73-5922, 73-2 USTC at 82,356, 82,357. The Court of Appeals for the Ninth Circuit affirmed, noting that with minor exceptions the contract involved was "in substance little different from a conventional installment sale of land with an escrow agreement." *Muheim v. United States*, 524 F.2d at 776.

The result in *Muheim* is similar to the result respondent contends for here. Because both parties conceded the fact of a sale and because of the particular facts of that case, we consider *Muheim* to be helpful but hardly decisive in determining whether, under her contract, petitioner retained an economic interest in the coal. However, after carefully reviewing the relevant case law and the specific facts and contract provisions of this case, especially the practical effect of the contract, we agree with respondent that under the instant contract, petitioner did not retain an economic interest in the coal.

Under the contract, petitioner is to receive a tonnage royalty of $1 per ton of coal mined. The maximum amount petitioner can receive is $4.3 million. In addition, under the contract, petitioner is to receive $430,000 as an annual minimum royalty each year for 10 years. Thus, the minimum amount she can receive is also $4.3 million. Any tonnage royalty petitioner receives during a year is credited against the annual minimum royalty for the year. If petitioner is due tonnage royalties during a year that exceed the annual minimum royalty for the year ($430,000), such excess is recouped against any annual minimum royalty received in past years and any remaining excess is applied as a prepayment of any annual minimum royalty due in the future. See note 6 *supra*. Thus, under the contract, petitioner will receive tonnage royalties and/or annual minimum royalties of $4.3 million, no more and no less, over 10 years or less, regardless of whether any coal is ever actually mined. Because petitioner will receive $4.3 million regardless of whether any coal is ever actually mined, she need not look to extraction of the coal for the return of her capital and, consequently, she has not retained an economic interest in the coal.

Understandably, petitioner does not agree. Petitioner says that she intended to, and must, look to tonnage royalties from extraction of the coal as her primary source of income. She argues that the provisions for tonnage and annual minimum royalties, recoupment of tonnage royalties against the annual minimum royalties, and due diligence in mining all work together to encourage extraction of the coal and the resulting payment of tonnage royalties. We do not agree with petitioner's assertion.

The contract's open-ended recoupment provision does not encourage extraction because Wellmore need not mine the coal within a limited period of time after paying an annual minimum royalty to avoid paying an additional tonnage royalty for the coal "paid for" with the annual minimum royalty. An example will illustrate the point. Under the contract, if Wellmore pays an annual minimum royalty of $430,000 in year one, it is relieved of the obligation to pay a tonnage royalty on 430,000 tons of coal regardless of when the coal is mined. If the contract limited the recoupment of tonnage royalties against annual minimum royalties to annual minimum royalties paid within, for example, 3 years of actual mining, tonnage royalties due on coal mined in year four could *not* be recouped against the annual minimum royalty paid in year one and would have to be paid *in addition to* such annual minimum royalty. Wellmore would in effect be paying for the coal twice. This arrangement would encourage Wellmore to mine coal within the recoupment period to avoid this result. On the other hand, the contract's open-ended recoupment provision *does not* encourage production because Wellmore will *never* have to pay a tonnage royalty on coal already paid for by annual minimum royalties. See also notes 6, 7 *supra*. We note that up to the date of the trial, Wellmore had not mined any coal from the property.

Nevertheless, petitioner emphasizes that by enacting what is now section 631(c), Congress intended to subsidize domestic coal production. While this may be true (see S. Rept. 781, *supra*, 1951-2 C.B. at 488), Congress required in section 631(c) that taxpayers retain an economic interest in coal before its disposition qualifies for the subsidy provided. This petitioner has not done. Her arguments to the contrary are unavailing.

Petitioner argues that, unless other provisions of an agreement compel a different conclusion, a lessor entitled to tonnage royalties dependent upon the quantity of mineral extracted retains an economic interest in the mineral. See *Gitzinger v. United States*, 404 F.2d at 194. As discussed above, we think that the provisions of the instant contract compel a different conclusion, namely, our conclusion that petitioner did not retain an economic interest in the coal. Petitioner contends that the existence of a maximum on tonnage royalties payable does not necessarily preclude retention of an economic interest, citing *Kittle v. Commissioner*, 21 T.C. 79 (1953), affd. per curiam 229 F.2d 313 (9th Cir. 1956). That case is inapposite. In *Kittle v. Commissioner*, 21 T.C. at 88-89, we held that the taxpayer retained an economic interest in iron ore even though the lessee was obligated to pay the taxpayer $10 million over 20 years as minimum royalties even if the lease was subsequently terminated. This $10 million represented a 50-cent-per-ton royalty on the first 20 million tons of iron ore mined. If more iron ore was mined, the lessee was obligated to pay a royalty thereon at the 50-cent-per-ton rate. 21 T.C. at 87. Thus, the $10 million minimum royalty was not the maximum the taxpayer could receive in that case except in the case of default.

Petitioner's arguments do not overcome the total effect of the contract, which precludes petitioner from having retained an economic interest in the coal. The fact that the maximum tonnage royalties payable equal the total annual minimum royalties, in conjunction with the open-ended

recoupment provision, in effect fixes the consideratio
petitioner will receive under the contract at $4.3 million
She will receive this amount regardless of whether any coa
is ever actually mined. Thus, she need not look to th
extraction of the coal for a return of her capital and henc
has not retained an economic interest in the coal.

Petitioner's alleged intent that the tonnage royaltie
would be her primary source of income is not controlling. I
is the intent of *both* parties to an agreement that must b
considered in determining whether an economic interest ha
been retained. *Gitzinger v. United States*, 404 F.2d at 195
The contract expressly provides that "the economic interes
in and to the coal in, on and under the [property] for incom
tax and all other purposes shall be deemed, construed an
shall be in [Wellmore]." While more than one party ma
hold an economic interest in mineral property (see *O'Conno*
v. Commissioner, 78 T.C. at 8-9), and while this contrac
language in regard to the economic interest does not contro
our decision, it nevertheless appears to be a clear statemen
of the parties' intentions as to who owns the economi
interest in the coal.

Petitioner also contends that she continued to participat
in the risks of mining and therefore retained an economi
interest in the coal. See *United States v. White*, 401 F.2
610, 614 (10th Cir. 1968). Indeed, we have said tha
economic interest and risk are inextricably related. *O'Con-*
nor v. Commissioner, 78 T.C. at 11. According to petitioner
she faces the possibility that, given the uncertain feast-or
famine nature of the Kentucky coal industry,[12] Wellmor
may be unable to meet either its mining or paymen
obligations under the contract. Petitioner also claims t
bear the risk of (1) the coal's somehow being destroye
before extraction, (2) Wellmore's "abandoning the job," (3
Wellmore's terminating the contract, and (4) Wellmore'
shareholders bankrupting the corporation so as to avoid it
obligations under the contract. Petitioner also waived any
right to hold Wellmore liable for any damage, destruction
or nuisance that may occur during the mining operations
Even if these speculative claimed risks exist, they are risk
that exist whenever one has a security interest in property

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[12] The Kentucky coal industry was described by Combs, the attorney who negotiated and drafted the contract for petitioner, as a feast or famine business.

that has been sold outright. Risk that evidences the existence of an economic interest exists only when one must look solely to extraction of the mineral resource in order to recover an investment. *O'Connor v. Commissioner*, 78 T.C. at 11. The risks cited by petitioner are not related to extraction, but are risks one has with any outright sale of property where payments are to be made on the installment basis, as here.

Petitioner's argument that she should not be denied section 631(c) treatment because she "minimized" her risk by contracting for annual minimum royalties is likewise unconvincing. In negotiating the contract, petitioner *eliminated* the risk that she would not receive a return of her investment in the coal if the coal were not extracted. Under the contract, she will receive $4.3 million for the coal regardless of whether any coal is mined. She bears no risk dependent upon extraction.

Petitioner next argues that in a typical coal lease the lessor retains an economic interest in the coal, citing *Wood v. United States*, 377 F.2d at 305, and insists that her contract is a typical coal lease. Respondent concedes that the contract is a typical coal lease in that it contains the usual "boilerplate" lease provisions. In addressing petitioner's argument, we need not definitively define a typical coal lease and compare the contract thereto. See, however, *Wood v. United States*, 377 F.2d at 305-307, particularly n. 14. We must consider the total effect of the contract (see *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 266-267 (1958)), which is that petitioner will receive $4.3 million regardless of whether any coal is ever mined. Such a result precludes petitioner's retention of an economic interest and most certainly does not occur in the "typical" coal lease.

Finally, petitioner suggests that consideration of the time value of money leads to the conclusion that she retained an economic interest in the coal. She repeats her argument that the contract's annual minimum royalty, "diligent mining" requirement and recoupment provision encourage Wellmore to mine the coal as soon as possible.[13] Wellmore could have mined all the coal during the early years of the contract and consequently would have been required to pay petitioner the

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[13] As noted earlier, we do not agree with this assertion.

$4.3 million as tonnage royalties as the coal was mined. Because of its immediate earning potential, $4.3 million paid during the early years of the contract would have been worth more to petitioner than $4.3 million paid as annual minimum royalties over 10 years. Petitioner could have received the $4.3 million in less than 10 years only if Wellmore had mined more coal than it had in effect paid for with previously paid annual minimum royalties and had to pay tonnage royalties in excess of the annual minimum royalty due for any particular year. Therefore, petitioner argues, she had to look to extraction of the coal for a return of her capital and thus retained an economic interest in the coal.

The fallacy in petitioner's argument is that the return *of* her capital is not dependent upon Wellmore's mining the coal. Under the contract, petitioner will receive $4.3 million over a period of 10 years regardless of whether the coal is mined. Petitioner may receive it sooner, depending on when the coal is mined, but she will nevertheless receive it. The return *on* petitioner's capital, that is, how much she can earn on the $4.3 million once she receives it, can vary depending on when the coal is mined, because the sooner petitioner receives it, the sooner she can invest it. Thus, although the value of the $4.3 million to petitioner as reflected in its earning power can be affected by extraction, petitioner's ultimate receipt of the $4.3 million is not in any way dependent upon extraction.[14] Therefore, she did not retain an economic interest in the coal.

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[14] The only specific authority petitioner cites in support of her argument that we must consider the time value of money is the following language from *Filgo v. United States*, 387 F. Supp. 1300, 1309 (N.D. Texas 1974):

> "The sole 'economic' distinction between a typical mineral lease and the 'agreements' in question here is that Texas Industries, Inc., the Grantee, lost the use of the $6,250 (an interest factor) from the time a $6,250 check for an 'increment' was delivered * * *"

Neither the case nor the quote has anything to do with any relationship between the time value of money and retention of an economic interest. In *Filgo*, the District Court determined that agreements providing for the extraction of sand, gravel, and fill dirt from the Filgos' property in large increments and also giving Texas Industries the option to purchase additional increments in effect gave Texas Industries the right to mine to exhaustion so that the Filgos retained an economic interest in the minerals in place and that the agreements were therefore leases and the payments received thereunder were minimum guaranteed advance royalties taxable as ordinary income. *Filgo v. United States*, 387 F. Supp. at 1304-1305. The decision rested in large part upon the option granted to Texas Industries to purchase additional increments of minerals. *Filgo v. United States*, 387 F. Supp. at 1304-1305. The language quoted by petitioner was simply an explanation that the only difference between the agreements in question and typical mineral leases was that Texas Industries was paying the

Respondent has argued throughout this proceeding, that because the maximum on tonnage royalties equals the total annual minimum royalties, the contract fixes a definite consideration ($4.3 million) that petitioner will receive regardless of whether any coal is mined. This precludes petitioner from retaining an economic interest in the coal, because she need not look to extraction for a return of her capital. In making her various arguments, petitioner has not, for the most part, directly addressed these clear consequences of the contract. Petitioner's only attempt in this regard is to suggest that the total amount of annual minimum royalties was determined by referring to the estimate that there were 4.3 million tons of recoverable coal in her property. Petitioner cites *Briscoe v. United States*, 210 Ct. Cl. 158, 536 F.2d 353 (1976), for the proposition that a minimum royalty based on an approximation of available reserves does not prevent the recipient from retaining an economic interest in the minerals in place. That is not the point. The contract sets a definite consideration petitioner will receive regardless of whether any coal is mined. This precludes petitioner's retention of an economic interest in the coal. As a number of commentators have warned: "A contractual right to receive a definite sum of money within a definite time, with interim payments measured by production, is not an economic interest, because the right to share in the [mineral] proceeds is incidental to the covenant to pay a sum certain." C. Russell & R. Bowhay, Income Taxation of Natural Resources, par. 2.12, at 213 (1986); Coggin, "Section 631(c): Disposal of Coal or Domestic Iron Ore with a Retained Economic Interest," 459 Tax Mgmt. A-4 (BNA 1984). See also *Vest v. Commissioner*, 481 F.2d 238, 243 (5th Cir. 1973), cert. denied 414

Filgos minimum guaranteed royalties in advance of actual extraction. A reading of the entire paragraph from which petitioner selectively quotes confirms this interpretation:

> "4. The total effect of the agreements here is that Texas Industries, Inc., agreed to pay minimum guaranteed royalties, albeit, in advance and in large units (25,000 cubic yards), for sand and gravel to be removed from the land by Texas Industries in the ordinary course of mining operations. The sole 'economic' distinction between a typical mineral lease and the 'agreements' in question here is that Texas Industries, Inc., the Grantee, lost the use of the $6,250 (an interest factor) from the time a $6,250 check for an 'increment' was delivered to Lee Filgo until the 25,000th cubic yard of sand and gravel in that increment was removed from the 168-acre tract. [*Filgo v. United States*. 387 F. Supp. at 1309.]"

This distinction was not determinative. *Filgo v. United States*, 387 F. Supp. at 1310.

U.S. 1092 (1973). After considering all of the facts of this case and reviewing petitioner's contract as a whole in the light of the pertinent case law, we conclude that petitioner did not retain an economic interest in the coal.

Having decided that petitioner did not retain an economic interest in the coal and is therefore not entitled to section 631(c) treatment, we next consider respondent's argument that because section 631(c) does not apply, the payments under the contract are subject to the imputed interest rules of section 483.[15] See sec. 483(b) and (c). Petitioner has focused only on the section 631(c) issue.[16] She has not addressed the applicability of section 483 if section 631(c) treatment is unavailable.[17] We could therefore deem petitioner to have conceded the issue. However, assuming petitioner has not conceded the issue, we think it clear that section 483 applies to payments petitioner received under the contract, given our holding that the payments do not qualify for section 631(c) treatment.

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[15] During 1980, sec. 483 provided in pertinent part as follows:

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) Amount Constituting Interest.—For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) Total Unstated Interest.—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of the payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) Payments to Which Section Applies.—

(1) In general.—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).,

[16] As noted above, if a transaction qualifies for sec. 631(c) treatment, sec. 483 does not apply. H. Rept. 749, 88th Cong., 1st Sess. (1963), 1964-1 C.B. (Part 2) 125, 198. See secs. 1.483-1(b)(1), 1.631-3(b)(1), and 1.631-3(c)(1), Income Tax Regs.

[17] In her reply brief, petitioner for the first time and in a rather strident tone contends that the notice of deficiency is arbitrary, excessive, and incorrect because of "Respondent's failure to abide by the Treasury Regulations (sec. 1.631-3(c)(1)(i), Income Tax Regs.) and the legislative intent underlying sec. 631(c) and as a result of its [sic] steadfast refusal to offer

In general, during 1980, section 483 applied to any payment on account of a sale or exchange of property due more than 6 months after the date of the sale or exchange under a contract under which (1) at least one payment is due more than 1 year after the date of the sale or exchange and (2) there is total unstated interest under section 483(b). Sec. 483(c). The transaction evidenced by the contract was a sale or exchange of property not coming within section 631(c) because petitioner did not retain an economic interest in the coal. See *O'Connor v. Commissioner*, 78 T.C. 1, 12 (1982). Therefore, the payments petitioner receives under the contract are on account of an outright sale or exchange of property, specifically a sale of a capital asset as defined in section 1221. At least one payment is due under the contract more than 1 year after its date. In fact, all of the annual minimum royalties are due more than 1 year after the date of the contract. In addition, all of the coal could be mined in 4 years, so even if all the coal had been mined

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evidence or to acknowledge the existence of certain provisions of the Coal Lease." Petitioner further argues that she has presented sufficient evidence to rebut the presumption of correctness that usually attaches to the notice of deficiency. Thus, she says, respondent bears the burden of proving the existence of a deficiency, which he has failed to satisfy because he has presented no evidence at all. Petitioner's arguments and the cases she cites are completely inapposite. See *Kenyatta Corp. v. Commissioner*, 86 T.C. 171, 179-181 (1986).

This case does not depend upon which party bears the burden of proof or upon the availability of the presumption of correctness. Our primary task here is to apply a rather basic tax concept (i.e., retention of an economic interest) to relatively straightforward facts revolving around a contract stipulated into evidence. Such an exercise does not involve weighing whether one party or the other has satisfied the burden of proof in offering evidence or convincing us that his or her version of the facts (as opposed to the legal consequences thereof) is the correct one. Moreover, we think the record contains all the facts necessary to our determination. The fact that petitioner rather than respondent supplied most of the evidence is not only irrelevant but hardly astonishing since she and her advisers possessed the documents and knowledge relevant to the transaction. Respondent's arguments in support of the inapplicability of sec. 631(c) and his emphasis on provisions of the contract favorable to his position do not make the statutory notice arbitrary, excessive, and incorrect. Petitioner even suggests that respondent "affirms that the Notice of Deficiency is, in fact, incorrect and excessive, arguing that Petitioner's tax liability should be recomputed using a new theory of the payments under the Coal Lease." The "new theory" is simply another method of computing the imputed interest under section 483, which respondent says would result in a lower deficiency for petitioner; the Court will not force petitioner to accept the benefit of this recomputation if she does not wish it. See note 18 *infra*. In short, petitioner's arguments in regard to burden of proof and the notice of deficiency are not only presented in an intemperate manner, but are simply wrong.

right after the contract was signed, at least some of th tonnage royalties would have been paid more than 1 yea after the contract date. There is total unstated interes because the contract does not provide for any interest. Se sec. 483(b); sec. 1.483-1(d), especially (d)(2), Income Ta Regs. Finally, none of the exceptions to section 483 apply See sec. 483(f); sec. 1.483-2(b), Income Tax Regs. Thu section 483 applies.

We sustain respondent's determination that $129,688.8 of the payment petitioner received under the contrac during 1980 is ordinary interest income.[18]

To reflect the foregoing,

Decision will be entered under Rule 15

GULF OIL CORPORATION, PETITIONER *v.* COMMISSIONER O INTERNAL REVENUE, RESPONDENT

Docket No. 22499-82. Filed August 11, 1986.

Petitioner designed, constructed, transported, and installed self-contained drilling and production platforms on properties in the Gulf of Mexico and the North Sea. In the process of design and construction, costs were incurred that petitioner seeks to deduct as intangible drilling costs (IDC) under sec. 263, Internal Revenue Code of 1954. Each of the platforms was designed for a useful life of approximately 20 years at the conclusion of which period each platform would have no salvage value to petitioner. *Held*, the costs incurred are deductible as IDC as they were not incurred in the acquisition of tangible property ordinarily considered to have salvage value. Sec. 263(c), I.R.C. 1954; sec. 1.612-4, Income Tax Regs.; *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349 (1981).

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[18] On brief, respondent suggests that the payments petitioner receives under the contract ar indefinite within the meaning of sec. 483(d), and that the interest portion of each paymen should therefore be calculated under sec. 1.483-1(e), Income Tax Regs. We will not conside matters first raised on brief. See *Neely v. Commissioner*, 85 T.C. 934, 943-944 (1985). Howeve this does not seem to be so much a new matter or even a change of legal theory as merel another method to compute the amount of imputed interest under sec. 483. Since responden indicates that such a calculation will result in a reduced deficiency, presumably interes income in an amount less than the $129,686.86, we will permit the parties, if they so desire, t recompute the deficiency if that can be accomplished on the record of this case and under Rul 155. The Court expresses no view as to the computation of such payments in subsequent ta years.

J. Waddy Bullion, Emily A. Parker, Sean T. Crimmins, Buford P. Berry, J. Y. Robb III, and *Margaret S. Alford*, for the petitioner.

Raymond L. Collins and *William B. Lowrance*, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax for the taxable year 1974 in the amount of $80,813,428 and for the taxable year 1975 in the amount of $166,316,320. Petitioner and respondent, with the approval of the Court, agreed that certain issues would be severed and tried at a special trial session which was held at Dallas, Texas.

One of the issues to be tried was designated by the parties as the "Intangible Drilling and Development Costs" issue. The issue for decision is whether petitioner may deduct as IDC under section 263(c),[1] certain costs incurred in the design and construction of offshore oil and gas drilling platforms.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated herein by reference.

Gulf Oil Corp. (hereinafter referred to as petitioner or Gulf) is a corporation organized under the laws of the Commonwealth of Pennsylvania with its principal office in Pittsburgh, Pennsylvania. During the taxable years at issue, Gulf and certain of its subsidiary corporations constituted an "affiliated group" as that term is defined in section 1504. Petitioner, directly and through its foreign subsidiaries and affiliates, is engaged in world-wide exploration, development, production, purchase, and transportation of crude oil and natural gas, and in the manufacture, transportation, and marketing of petroleum products.

Gulf, as the common parent of an affiliated group of corporations, timely filed consolidated Federal income tax returns for its taxable years 1974 and 1975 on behalf of itself, and certain of its subsidiary corporations, with the Office of the Internal Revenue Service at Pittsburgh, Pennsylvania.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable years in issue, and all Rule references are to this Court's Rules of Practice and Procedure.

Petitioner maintained its books of account for the taxable years in issue on the accrual method of accounting using the calendar year as its taxable year. Prior to and during the taxable years at issue, petitioner elected to deduct as current expenses all intangible drilling and development costs (hereinafter sometimes referred to as IDC) in accordance with section 263(c) and section 1.612-4, Income Tax Regs. The IDC costs at issue were incurred with respect to properties in the Gulf of Mexico and in the North Sea.

During the taxable years in issue, petitioner incurred costs to design and construct self-contained drilling and production platforms to be installed on oil and gas properties located in the Gulf of Mexico in which it had a working or operating interest (hereinafter referred to as a working interest). The working interests were obtained pursuant to either a lease or assignment of a lease with respect to each property. The leases generally specify that the platforms are to be removed from the installation site within 2 years of the end of production or upon obsolescence.

The year placed in service, location of the platform, identifying number of the platform, and petitioner's share of the working interest were as follows:

Year placed in service	*Platform location*	*Platform identification*	*Petitioners share working interest*
1975	South Pass Block 62	South Pass 62A	50%
1975	South Pass Block 61	South Pass 61B	100
1975	Eugene Island Block 313	Eugene Island 313A	50
1976	Eugene Island Block 313	Eugene Island 313B	50
1976	Grand Island Block 93	Grand Island 93C	45
1975	West Cameron Block 266	West Cameron 266A	50
1977	South Pass Block 77	South Pass 77A	33⅓
1976	Vermilion Block 23	Vermilion 23A	33⅓
1976	South Pass Block 62	South Pass 62B	50

Year placed in service	*Platform location*	*Platform identification*	*Petitioners share working interest*
1975	South Timbalier Block 37	South Timbalier 37A	33⅓%
N/A	South Timbalier Block 36[1]	South Timbalier 36D	100
1975	South Timbalier Block 36	South Timbalier 36B	33⅓

[1] This platform was used primarily for soil testing purposes rather than for production.

After installation, wells were drilled from each of these platforms in the Gulf of Mexico. Set forth below for each self-contained drilling and production platform is the operator, the number of wells drilled, the number of wells producing as of the time of trial, and the type of production from the wells, and certain characteristics of the platform.

Platform name	*Operator*	*Wells drilled/ producing*	*Type of wells*	*Platform*
South Pass 62A	Gulf	34/19	19 oil	8 main piles 4 skirt piles 24 well slots
South Pass 61B	Gulf	2/0	N/A	8 pile 15 well slots
Eugene Island 313A	Texaco	18/7	6 oil 1 gas	8 pile 15 well slots
Eugene Island 313B	Texaco	21/10	7 oil 3 gas	8 pile 18 well slots
Grand Island 93C	Mobil	6/6	6 gas	8 pile 12 well slots
West Cameron 266A	Gulf	13/4	4 gas	8 pile 18 well slots
South Pass 77A	Chevron	16/11	3 oil 8 gas	4 pile 12 well slots
Vermilion 23A	Mobil	10/5	5 gas	8 pile 18 well slots
South Pass 62B	Gulf	9/7	7 oil	8 main piles 4 skirt piles 24 well slots
South Timbalier 37A	Gulf	15/6	4 oil 2 gas	8 pile 2 well slots
South Timbalier 36D[1]	N/A	N/A	N/A	N/A
South Timbalier 36B	N/A	21/15	5 oil 10 gas	8 piles 21 well slots

[1] This platform was used primarily for soil testing purposes rather than for production.

The offshore platforms at issue in the Gulf of Mexico are all of one basic type, namely self-contained drilling and production platforms. This differs from the tender platform, which is used for installations closer to shore, and which was used more frequently before the mid-1960's. A tender platform is so-called because it is necessary to anchor a barge or tender alongside the platform during drilling to accommodate and store part of the drill pipe and other material and equipment used in drilling. A self-contained platform is so named because some or all of the drill pipe and other materials and equipment used in drilling can be accommodated and stored on the platform. The self-contained platform was developed to decrease the number of work stoppages due to rough weather that required disconnecting the tender and it is also generally larger and heavier than a tender platform.

Prior to the time of completion of a platform, there are four phases that may be briefly described as follows: (1) The onshore design and construction phase; (2) the loading phase, consisting essentially of the removal of the platform from the shipyard or other site or facility where it was constructed and its preparation for transportation to the desired location; (3) the transportation phase, consisting of the transportation of the platform to the desired location; and (4) the installation phase, consisting of positioning, erecting, and anchoring the platform at the desired location.

Normally, after acquisition of the lease, an exploratory well is drilled, usually by means of a jack-up rig, in order to confirm the economic feasibility of placing a platform on the lease. If the well is a producer, the location for the platform is selected by Gulf or the operator (with the concurrence of the other working interest owners), and the design criteria for the necessary platform are developed.

Each platform is designed and constructed for the conditions at the specific location at which it is to be installed. No two platforms have the same design criteria, although the basic structural design is similar for all self-contained drilling and production platforms. Gulf's design and engineering personnel gather information with respect to the proposed platform site and develop the basic design for each specific platform. They consider soil conditions, storm ratings, water depths, tides, wave forces, and well spacing.

These factors affect the number and depth of wells desired, size and configuration of the drilling rig to be used, the loads imposed by the wells and lateral loads, types, strength and thickness of steel, size of members, and type of bracing. They utilize computer-generated design programs. The soil data includes the strength and adhesion characteristics of the soil which determine how deep the piles should and can be driven and the capacity that the pile can accommodate. The meteorological data are based on both normal conditions and the conditions that might be encountered by the platform during the worst storm that could be expected during a 100-year period (otherwise known as a 100-year storm). Water depth is critical in the design process, as are the 100-year storm waves, the current, and the tides. Wave loading affects every member of the structure because of the lateral, or horizontal, stress or load placed on the structure. The location is also important as the soil and water conditions will vary if the site is close to the mouth of a river or, conversely, many miles offshore. For example, at the mouth of the Mississippi, the additional stresses caused by the variations in soil conditions and water depth require the use of skirt piles to protect the main piling from lateral stress. The structure must also be designed to withstand the maximum live drilling loads or movable loads, caused by activity on the platform, as well as the vertical or dead load caused by the mass and weight of the structure. A critical external criteria that must be determined is the function to be served by the platform, i.e., the number of wells to be drilled, the depth to which the wells are to be drilled, the type of drilling, and the method of transporting the hydrocarbons to the shore.

Once the design has been completed, the plans and specifications are prepared, at least partially by computer, and sent out for bid. The successful bidder then constructs the structure under the supervision of Gulf's employees. The process of fabrication or construction and the process of installation are not always done by the same contractor. If not, the completed structure is stored on shore until the barges arrive for the transportation of the platform to the site.

Each of the platforms in the Gulf of Mexico in contr versy consisted of three major components which wer constructed onshore: (i) The deck, (ii) the jacket, and (iii) th piling. In general terms, the deck section is the portion c the structure that holds the drilling rig, drill pipe, an production equipment; the jacket is the underwater bracin system which is put into the water first; and the pilings ar driven through the legs of the jacket to anchor th platform.

A deck section for a basic jacket-type platform in th process of construction, and even after completion an readiness for load-out, hypothetically can be used with different jacket and at a different location than tha originally contemplated, but generally only after structur analysis and expensive modifications. In addition, a par tially or fully completed jacket section hypothetically can b modified for use at a different location and with a differen deck section than that originally contemplated. All suc modifications of either decks or jackets are undertaken onl if they are considered to be economically feasible, takin into consideration all of the requisite costs.

During and after the construction process, a platfor jacket, subject to economic constraints, can be modified fo use in water depths varying by 5 to 10 feet from the dept anticipated in the original design. Only after the jacket ha been installed in place, and if the lifting capacity to raise i does not exist, is it no longer subject to such modificatio Deck sections can be manufactured or prefabricated i advance of knowing the specific location of installation c the platform, although this was not Gulf's practice. Such procedure will tend to accelerate drilling projects and reduc "lead time." This is accomplished by designing the platfor deck to withstand the most severe requirements that ma reasonably be anticipated, which is more expensive tha designing each platform to the minimum specificatio required by installation in a particular location. In som instances, decisions have been made not to use platfor components once constructed. Such components then b come surplus and are available for purchase, modificatio or other use.

After being constructed onshore, the three major components of each platform in the Gulf of Mexico are loaded on a ship or barge for transportation to the platform location. The barge is towed to the installation site and the jacket is skidded off the barge into the water. The upending procedure consists of controlled flooding of the legs of the jacket, which are steadied by a derrick hook. Once the jacket is sitting on the bottom, it is leveled with the use of surveying instruments and is then ready for driving of the pilings.

Pilings are used to provide structural stability by means of the friction between the piling and the soil. Several pilings are set before the driving process begins. Frequently the piling will penetrate to a depth between 30 and 50 feet as a result of its own weight before being driven. Once set, the piling is driven by a hammer to a specified depth. Sections of piling are then added to the previously driven section. The length of the piling used and the depth to which it is driven are controlled largely by the weight of the hammer used to install it. Petitioner makes allowances for overdriving and underdriving. Underdriving means that the piling can be driven to a lesser depth than it was designed for; overdriving means that the piling can also be driven to a deeper depth than that for which it was designed.

Once the piling is driven to the specified depth, the grouting process begins. Grouting, a specialized form of cement without aggregate, stiffens the structure by filling the gap or annulus between the leg of the jacket and the piling. Structures that are designed to be moved are not grouted. Gulf grouts the legs of all of its self-contained drilling and production platforms.

After installation and leveling of the jacket and completion of the grouting, the deck section is lifted and positioned upon the structure. The deck column has stabbing guides that fit into the top of the piling. The deck is then welded in place. The self-contained drilling and production platform, once installed, begins its productive life.

During the taxable years in issue, petitioner also incurred costs to design and construct five large platforms to be installed on four oil and gas properties located in the North Sea in which it had a working interest. Gulf was a member of the Statfjord Group, consisting of licensees in areas of the North Sea governed by Norway and the United Kingdom and unitized into one operational unit. Mobil was selected as operator for the development of the unitized field. The year placed in service, block location of the platform in the North Sea, identifying number of the platform, and petitioner's share of the working interest were as follows:

Year placed in service	*Platform location*	*Platform identification*	*Petitioners share of working interest*
1977	211/23	Dunlin/No. 3016, 4001, 5501	9.80%
1984 (est.)	211/28	Hutton/No. 4013	16.70
1977	33/9	Statfjord A/No. 5502	5.30
1981	33/12	Statfjord B/No. 5503	5.30
1977	211/18	Thistle/No. 4015	5.33

Wells were drilled from each of these platforms following installation. Set forth below for each of the platforms, all of which are self-contained drilling and production platforms, is the operator, the number of wells drilled, the number of wells producing as of the time of trial, the type of production from the wells, and certain characteristics of the platform:

Platform name	*Operator*	*Wells drilled/ producing*	*Type of wells*	*Platform*
Dunlin	Shell	27/18	oil	4 column gravity based concrete 48 well slots
Hutton	Conoco	N/A	N/A	tension leg 32 well slots
Statfjord A	Mobil	28/14	oil	3 column gravity based concrete 42 well slots
Statfjord B	Mobil	11/9	oil	4 column gravity based concrete 42 well slots
Thistle	Britoil	44/32	oil	4 column steel 60 well slots

The Hutton platform was to be installed in 1984. Once this platform was installed, the operators planned to drill 14 wells, 2 of which will be for oil production, and 12 of which will be for water injection.

The general sequence of events from design through installation is the same for the platforms in the North Sea as for platforms in the Gulf of Mexico: the design and construction phase; the load-out or tie-down phase; the transportation phase; and the installation phase. Differences in design, construction, and installation are caused by constraints imposed by compliance with Government policy and the functional needs to insure economic production from the particular field, as well as physical constraints imposed by the much greater depth of the water and ferocity of the weather.

The design process for the North Sea platforms is far from routine, due both to the physical conditions and to the involvement of not only the various working interest owners, but also the Governments of Norway and the United Kingdom. The physical conditions are far less placid than those in the Gulf of Mexico. For example, the usual design criteria for a 100-year storm in the upper North Sea includes waves from 95 to 100 feet high and winds from 145 to 150 miles per hour. Although the design criteria, plans, and specifications for the plans for each of these platforms were joint efforts of a number of different entities, Gulf participated to the fullest extent possible.

Unlike the platforms in the Gulf of Mexico, the platforms in the North Sea varied in type. The Thistle platform was a steel-jacketed platform of a much larger size than the platforms in the Gulf of Mexico. A second type was the concrete and steel, gravity base structure used for the Dunlin, Statfjord A, and Statfjord B platforms. The final type of platform at issue was the tension leg design used for the Hutton platform.

The design criteria were specific to the soil and environmental conditions expected at each individual site. Furthermore, each platform was specifically designed both for its physical location and for the functions that it was to fulfill in terms of number and depth of wells desired, well spacing, and the size and configuration of the drilling rigs to be used. The platforms are also designed specifically for other characteristics of the oil field at which they are to be installed, for example. the ratios of oil and gas expected upon production.

In the case of the Hutton platform, the technology was a considerable advancement from that used in previous platforms, requiring the participation of Gulf, Conoco, Amoco, and a consortium of other major oil companies. The design was begun in 1979, with construction beginning in 1981. As the plans developed, the original planned design had to be enlarged thereby affecting the size and number of the tethers or anchor lines needed to attach the platform to the sea bottom. The tethers and tension legs are designed for a particular water depth and a particular load. The platform, as constructed, is not as rigidly fixed to the bottom as the Gulf of Mexico platforms, but is designed to "give" or allow the platform to lean slightly with the forces of the waves. The primary benefit of the initial buoyancy of the North Sea platforms, including the Hutton platform, is that they are less expensive than they would otherwise be to move to the installation site and may be easier to remove for disposition upon completion of their useful lives.

The installation process is different for the self-contained platforms in the North Sea than for the installation process for the self-contained drilling and production platforms in the Gulf of Mexico. Because the structures involved are larger than the available barges, flotation is built into the structures so that the deck or module support frame can be floated out to the site as one unit and then flooded and fixed into place by means of multiple piles or tethers. For example, the Thistle platform was installed on top of forty-two 54-inch piles which were driven to a depth of 450 to 470 feet below the surface of the sea bed. The gravity based platform also relies upon the use of concrete to maintain itself in a particular location by the sheer mass and weight of the platform. Such platforms also offer the advantage of additional storage in the hull which is used to store oil for loading onto tankers before the installation of pipelines. The installation of each of these types of platforms: the large steel jacketed platform, the tension leg platform, and the gravity type concrete platform, is a lengthy process involving towing, filling with ballast, assembling, and grouting. Frequently the buoyancy of the platforms is not adequate during towing to transport all of the necessary equipment, thus requiring the use of barges with derricks, and an even lengthier installation period. The platforms in the North Sea are all buoyant to some extent, at least until the ballast system is filled, and are thus generally referred to as floating. The buoyancy makes it possible to readjust the location of the platform slightly so long as the procedure for filling with ballast is still active.

With respect to the platforms in the North Sea, petitioner was unable to identify the portion of its total costs deductible as IDC prior to filing its Federal income tax returns for the taxable years in issue. Therefore, petitioner did not deduct any such costs on its returns as originally filed. Upon audit, petitioner filed claims for refund based upon the deduction of such costs. For the taxable year 1974, petitioner claimed IDC deductions relating to platform costs of $3,631,075. For the taxable year 1975, petitioner claimed deductions relating to platform costs of $10,558,200.

Offshore platforms, including those designated as "drilling" platforms, are long-lived assets, designed for useful lives in excess of 20 years. The loads placed upon the platforms and the corrosion caused by weather and water eventually destroy the structure. The period during which wells are drilled and prepared for production is usually short relative to the full useful life of the platform. Thereafter, the platform is primarily or solely involved in production for the remainder of its useful life, although from time to time thereafter some reworking of one or more of the wells or the drilling of one or more additional wells occurs. During such activities, production will normally continue as to the other existing wells. In addition, even during the drilling of wells, production will normally commence on the first well while additional wells are being drilled. All of the platforms in controversy in this case were still in place as of the time of trial and, with the exception of the Hutton platform, are actively producing oil or gas. Shortly after installation, each platform has been predominantly or entirely involved in production rather than in drilling and development.

The process of removal of a self-contained grouted platform of the type used by Gulf in the Gulf of Mexico would be a multistep process. All reusable equipment such as crew quarters and drilling and production equipment would be removed from the platform and salvaged. All of the wells but those necessary to supply the power necessary for the removal process would be shut in or plugged and the pipelines would be destroyed. The process of platform construction would then be reversed, with removal of the superstructure first. The piling would then be cut and discarded. Shaped explosive charges can be used to cut pilings at or below the surface of the sea bed. This enables the platform to be removed for disposition, but not necessarily for placement at another site. The grouting would have to be removed, which is a tremendously expensive operation, and is normally done only onshore. Gulf has never removed the grouting from a structure. The jacket, with or without the pilings, would then either be towed away or floated away using floating tanks. Removal does not, however, necessarily mean that the structure could be economically reused or relocated, even if the design criteria at the new location were identical to the original location. Substantial and costly modification would be required. The specific design of the deck and the jacket once constructed for the original installation would preclude economical reuse of these components with new components even if the structures were in good condition. Further, although the technology existed for removal of the platforms during the taxable years at issue, the technology necessary for the reinstallation of these particular platforms was only hypothetical at that time.

Although petitioner has upwards of 423 platforms in the Gulf of Mexico, Gulf has never removed and relocated a self-contained drilling and production platform. Gulf has only removed one self-contained drilling and production platform, the South Pass 61A platform, when it was damaged by Hurricane Camille shortly after its installation. The jacket, piling, and deck were removed, towed to deep water, and sunk. Production from another platform, the South Pass 61B platform, ceased shortly after drilling. Despite study, Gulf has failed to find an economical use for the platform or any of its components, and has determined to solicit bids to scrap it.

Some platforms or parts of platforms of types different from those involved here were removed and reused by others before or during the taxable years at issue. In 1966, Humble moved a tender-type structure approximately 30 miles from the South Pass 36A lease to the West Delta 73 lease. In 1968, Gulf moved a platform from Block 82, Grand Isle, to West Delta Block after substantial modifications. Both locations were in the same depth of water. In 1975, Shell moved a shallow water structure from a 30-foot depth to a 40-foot depth. In 1980, Sun moved a drilling deck approximately 75 miles. In 1982, portions of the Pemex platform in the Gulf of Mexico off Padre Island were removed after a blowout and fire, and reset approximately 700 yards away from its initial site. In each situation described above, an important portion of the structure was replaced in the reinstallation process.

The hypothetical process of removal of platforms in the North Sea is complicated by the complexity of the design. Gulf and the other owners of working interests in the North Sea fields have studied at length the problem of the disposition of the North Sea platforms, as it is both a technological and political problem. Removal will eventually be necessary, however, as international law and the relevant leases require their removal upon obsolescence. The cost of removal for each North Sea platform has been estimated at between $200 million and $400 million. Even the "floating" platforms are partially grouted in place, which makes them extremely difficult to remove. The process of removal would also require decommission and deactivation of all of the equipment, which would destroy its value for resale, even assuming that the underlying superstructure was still in good condition. The most frequently discussed method of removal is to take sufficient weight off the top, deballast, and pump underneath the platform to make the platform more buoyant, possibly add additional buoyancy tanks, and then tow the platform 300 miles to deep ocean dumping grounds. While the platforms in the North Sea have been described as "floating," their buoyancy is insufficient to allow relocation and is used simply to facilitate the installation and removal process.

The platforms cannot be simply moved to another location and reused because of their site-specific design, technological obsolescence, and damage resulting from corrosion and metal fatigue. Although there has been some discussion in the industry that such platforms might be reusable in another oil field, the platforms, once completed, are specific to the particular site at which installed. The procedures used for a reflotation and removal would effectively cause or complete destruction of the platform and all possibility of reutilizing the platform. The proposals for removal of the North Sea platforms are largely hypothetical as none of the North Sea platforms, as of the time of trial, have been either removed or refloated, much less relocated.

Each of the platforms in controversy, whether installed in the Gulf of Mexico or the North Sea, was designed, constructed, transported, and installed under petitioner's supervision (or the supervision of the operator of the oil and gas property) by independent contractors. With the exception of the Hutton platform, which was not installed as of the time of trial, each of the other platforms in controversy in this case are located at the site at which they were initially installed. Petitioner did not intend to reuse any of the platforms in controversy at any other location nor were any plans formed by which such reuse would be technologically or economically feasible.

The following schedule shows, for each of the self-contained drilling and production platforms in controversy, the type of platform design, the water depth in which the platform was installed, and the weight in tons of the deck section, the jacket section, the pilings, and the total weight.

GULF OF MEXICO PLATFORMS

Platform[1] name	*Type of platform*	*Water depth*	*Weight in tons*			
			Jacket	*Deck*	*Piling*	*Conductors*
South Pass 62A	8 pile	340	3800	950	2200	780
South Pass 61B	8 pile	230	1110	375	1195	N/A
Eugene Island 313A	8 pile	236	1450	568	N/A	N/A
Eugene Island 313B	8 pile	240	1468	658	N/A	N/A
Grand Island 93C	8 pile	218	N/A	N/A	N/A	N/A
West Cameron 266A	8 pile	80	527	408	477	165
South Pass 77A	4 pile	220	2385	650	2460	N/A
South Pass 62B	8 pile	375	2990	940	2336	873
South Timbalier 37A	8 pile	57	664	378	436	269
South Timbalier 36B	8 pile	57	664	378	436	269

[1] The requisite numbers for completion of this table for Vermilion, 23A, and South Timbalier 36D were not provided to the Court.

NORTH SEA PLATFORMS

Platform name	*Type of platform*	*Water depth*	*Total weight (metric tons)*
Dunlin	4 column gravity based concrete	495	253,723
Hutton	tension leg	485	47,400
Statfjord A	3 column gravity based concrete	478	650,000
Statfjord B	4 column gravity based concrete	476	781,000
Thistle	4 column steel	530	31,000 (jacket only)

On July 1, 1982, the Commissioner timely issued a statutory notice of deficiency to petitioner, determining deficiencies in the amounts of $80,813,428 for the taxable year 1974, and $166,316,320 for the taxable year 1975. The Commissioner disallowed the deductions for "IDC type" costs in respect of offshore drilling and development platforms located in the Gulf of Mexico in the amounts of $6,752,598 for the taxable year 1974, and $5,459,328 for the taxable year 1975. After concessions and adjustments, the amounts of IDC which are still in dispute for IDC costs with respect to the platforms in the Gulf of Mexico are $356,888 for the taxable year 1974, and $6,106,547 for the taxable year 1975, divided among the respective platforms as follows:

Platform	*Amounts disallowed*	
	1974	*1975*
South Pass 62A	$525,054	$641,273
South Pass 61B	(363,454)	812,214
Eugene Island 313A	129,347	1,926,360
Eugene Island 313B	- - -	35,556
Grand Island 93C	34,631	652,674
West Cameron 266A	31,310	1,097,808
South Pass 77A	- - -	628,005
Vermilion 23A	- - -	215,097
South Pass 62B	- - -	97,560
Total	356,888	6,106,547

With respect to the platforms in the North Sea, the Commissioner disallowed 60 percent of the IDC type costs claimed by petitioner in the amounts of $2,178,645 for the taxable year 1974, and $6,334,920 for the taxable year 1975. The balance of the deductions claimed by petitioner relating to platform costs in each of the 2 taxable years was allowed as a deduction by the Commissioner, and the deduction of such costs is not in controversy.

OPINION

The issue is the deductibility of costs claimed as IDC with respect to offshore platforms in the Gulf of Mexico and the North Sea. The determination of the Commissioner in his statutory notice of deficiency is presumptively correct, and petitioner has the burden of disproving each individual adjustment. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). In addition, petitioner bears the burden of proving the overpayments which it claims. Petitioner, therefore, bears the burden of proving that the costs at issue qualify for deduction as intangible drilling costs.

Respondent contends that the costs at issue are capital expenditures under section 263(a), and that the costs do not qualify for the optional IDC treatment under section 263(c) and section 1.612-4, Income Tax Regs. His basic position is that the costs were incurred in the acquisition of tangible property ordinarily considered to have salvage value. Petitioner contends that the costs incurred do qualify for the optional IDC treatment as neither the platforms at issue nor their major components (deck, jacket, and pilings) can ordinarily be considered to have salvage value.

The general rule of section 263(a) is that no deduction shall be allowed for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 263(c) and section 1.612-4, Income Tax Regs., promulgated thereunder, are an exception to the general rule, and provide that taxpayers have the option to deduct, rather than capitalize, intangible drillings costs, as that term is defined in the regulations.

The history of the intangible drilling costs deduction is a complex one, which has been detailed at length elsewhere. *Exxon Corp. v. United States*, 212 Ct. Cl. 258, 547 F.2d 548, 553-555, 563-564 (1976) (hereinafter sometimes referred to as the *Exxon* case); *Standard Oil Co. (Indiana) v. Commissioner*, 68 T.C. 325, 345 n. 9 (1977). The salient points are that the option to deduct IDC was originally allowed without the benefit of statutory authority; then it was questioned in the courts, and finally received congressional imprimatur[2] and full legal status in section 263(c), which provides:

> SEC. 263(c). INTANGIBLE DRILLING AND DEVELOPMENT COSTS IN THE CASE OF OIL AND GAS WELLS.—Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress.

The regulations concerning the deduction of IDC's have remained remarkably consistent in both language and policy, from their inception in 1916 (T.D. 2447 (unpublished), relating to the Revenue Act of 1916) to the present. Section 1.612-4, Income Tax Regs., which is conceded by both parties to contain the controlling criteria for the decision of this case, provides:

> Sec. 1.612-4. Charges to capital and to expense in case of oil and gas wells.
>
> (a) *Option with respect to intangible drilling and development costs.* In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used—
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[2] In *F.H.E. Oil Co. v. Commissioner*, 147 F.2d 1002 (5th Cir. 1945), the Fifth Circuit Court of Appeals held that the regulation which permitted a taxpayer to deduct expenditures for capital improvements, was contrary to law. 147 F.2d at 1005. This decision prompted Congress to adopt Concurrent Resolution 50, 79th Cong., 1st Sess., 59 Stat. 844 (1945), which recognized and approved the Treasury regulations "granting the option to deduct as expenses such intangible drilling and development costs."

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

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(c) *Nonoptional items distinguished.* (1) Capital items: The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are recoverable through depreciation.

We have previously considered the application of the provisions governing the deduction of intangible drilling costs at length and in detail, most recently in *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349 (1981) (hereinafter sometimes referred to as the *Standard Oil* case). In that opinion and other opinions by this Court, the Court of Claims, and most recently, the U.S. District Court for the Southern District of Texas, the regulations have been interpreted and applied in accord with the fact that "Congress favors a liberal interpretation of the regulation." *Texaco, Inc. v. United States of America*, 598 F. Supp. 1165

(S.D. Texas 1984) (hereinafter sometimes referred to as the *Texaco* case); *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. at 386-387; *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456, 1475 (1980), affd. 694 F.2d 648 (10th Cir. 1983); *Sun Co. v. Commissioner*, 74 T.C. 1481, 1508 (1980); *Standard Oil Co. (Indiana) v. Commissioner*, 68 T.C. at 345; *Exxon Corp. v. United States*, 547 F.2d at 555. Respondent urges us to review our position, and construe these provisions narrowly, citing *Deputy v. du Pont*, 308 U.S. 488 (1940), and *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934). We see no reason to change our view that an overly restrictive approach to these regulations is inappropriate in light of the view in Congress that the IDC option is an incentive to oil and gas prospecting and exploration, a continuing objective of national importance. *Exxon Corp. v. United States*, 547 F.2d at 555.

The opinions in *Exxon*, *Standard Oil*, and *Texaco* dealt with many of the arguments set forth by respondent and petitioner in the instant case at length and in detail. The primary difference is that the platforms at issue in this case are of a different type and placed in different locations than those considered previously.

We, therefore, apply the provisions of section 1.612-4(a), Income Tax Regs., in the same fashion as in the prior cases, leaning heavily on the able work that has been done before. As the regulation states, the types of costs subject to the IDC option are described as "wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas." As noted above, all of the costs at issue were incurred with respect to platforms that were initially used for drilling and subsequently used for production and drilling operations as appropriate. The costs were incurred either directly by petitioner or by petitioner's contractors, again in accord with the regulation. Finally, the costs were incurred with respect to the design and construction of offshore drilling and production platforms that are essential for the drilling of wells and the preparation of wells for the production of oil and gas. Sec. 1.612-4(a)(3), Income Tax Regs. These are the specific types of costs included within the regulation.

The regulation limits the availability of the IDC option to "expenditures for those drilling and developing items which in themselves do not have a salvage value." However, IDC "are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value." "Installation" includes construction at a location other than the actual site upon which the platform is finally installed. *Exxon Corp. v. United States*, 547 F.2d at 556. The regulation distinguishes nonoptional items, which include "expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value." Sec. 1.612-4(c)(1), Income Tax Regs. Examples of such items include "actual materials in those structures" and "drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc."[3]

Past opinions have differentiated between the "actual materials" referred to in section 1.612-4(c), Income Tax Regs., and other costs and concluded that the physical and tangible materials that are transformed via labor, fuel, etc., into the desired assets for drilling are the "actual materials" rather than the completed platforms or their major components (deck, jacket, piles, etc.) as urged by respondent. The result of this conclusion is that the availability of the IDC option for the costs at issue will depend on whether these costs are expenditures by which the taxpayer has acquired tangible property ordinarily considered as having salvage value. Sec. 1.612-4(c), Income Tax Regs.

We hold that the "not ordinarily considered as having a salvage value" test contained in section 1.612-4(c), Income Tax Regs., is an objective test to be applied to the types of platforms involved here as used in the oil industry in general, rather than a more limited test based upon the use by a particular taxpayer who claims the IDC election. This is the manner in which the Court of Appeals for the Tenth Circuit viewed the use of surface casing in *Harper Oil Co. v. United States*, 425 F.2d 1335 (10th Cir. 1970), and the manner in which the U.S. District Court for the Southern

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[3] Other types of costs that are not subject to the option are intangible costs connected with equipment, facilities, and structures that are not incident to or necessary for the drilling of wells "such as structures for storing or treating oil or gas." The costs at issue in this case do not fall within this nonoptional category.

District of Texas more recently viewed the use of offshore platforms in *Texaco, Inc. v. United States, supra.*

The parties differ on the point in time at which we should examine the platforms to see whether they are ordinarily considered as having a salvage value. Petitioner contends that the examination should be made at the time of acquisition. Respondent contends that the examination should be made at the time drilling is terminated. This was the position of the Government which the court rejected in *Texaco, Inc. v. United States, supra.* We agree with petitioner and the *Texaco* analysis.

Respondent reasons that once the platform is no longer used for drilling, it is no longer at risk, and because IDC and risk are so inextricably related, the examination should be made when drilling ceases. We have consistently held that IDC and risk are inextricably related. *Standard Oil Co. (Indiana) v. Commissioner,* 68 T.C. at 350. The risk referred to, however, is the general risk of exploration for, drilling, and producing hydrocarbons and that risk does not cease at an arbitrary time prior to the end of the use of the platform in the taxpayer's trade or business. Drilling and production are not mutually exclusive, as shown by the record before us. Drilling customarily continues after production is attained on the first well and will usually continue until all locations have been explored. Production may or may not continue during this period. Therefore, we cannot agree that examination of the platform for its possible salvageability should be made at the end of its use for drilling, even if that date necessarily coincided with commencement of production, which it rarely does.

As a practical matter, the determination of whether a platform can ordinarily be considered to have salvage value must be made at the time of acquisition. To find otherwise would mean that a platform from which production is attained would not qualify for IDC. Congress never indicated any intent to allow the IDC election only for unsuccessful efforts to find hydrocarbons. Furthermore, delay in determining salvageability would leave in limbo for periods extending into several annual accounting periods the question as to whether a particular platform would qualify for the IDC election or would, instead, be subject to an annual deduction for depreciation.

The application of the IDC election for platforms must be consistent with the depreciation regulations because if the platforms do not qualify for IDC they do qualify for depreciation. Section 1.167(a)-1(c), Income Tax Regs., specifically provides that the amount of salvage value is determined at the time the asset is acquired. It necessarily follows that the determination of whether the asset is ordinarily considered as having a salvage value under section 1.612-4(c), Income Tax Regs., must be made at the same point in time.

If the salvageability were determined at the end of the drilling period it would bifurcate the period of the useful life of the platform. This would be also contrary to section 167 because it defines useful life as the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of income. Sec. 1.167(a)-1(b), Income Tax Regs. The platform, once drilling ceases, continues in use to the taxpayer as a production platform. It would be absurd to hold that a single platform has one useful life while being used for drilling purposes under section 1.612-4(c), Income Tax Regs., and another useful life for production purposes under section 1.167(a)-1(b), Income Tax Regs.

We have previously stated, with the support of the regulations, that "the salvageability of the item in question should be determined with an eye toward the ordinary manner in which it is used," (*Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. at 399), a view which the District Court in *Texaco* notes "reconciles clearly with the *Harper Oil* analysis." *Texaco, Inc. v. United States, supra* at 1175. The platforms at issue are designed, constructed, and installed with the purpose of both drilling and production, oftentimes simultaneously. The useful life of the platforms is readily determinable by reference to obsolescence and fatigue. When a platform ceases to be used in a taxpayer's trade or business is an identifiable event easily ascertained. The cessation of drilling, on the other hand, depends upon many factors and conditions not readily ascertained. Furthermore, determining salvage value at this time disregards the demonstrated fact that the useful life includes not only the time spent drilling, but also the much longer period of production.

An objective review of the evidence indicates that the platforms at issue and their components are not, at the time of acquisition, ordinarily considered as having a salvage value. Although petitioner has upwards of 423 platforms in the Gulf of Mexico, it has removed only a small number of them before and during the taxable years at issue, and reinstalled components thereof rarely and only after substantial modifications. None of the removed platforms were either the size, complexity, or type of self-contained drilling and production platforms. It is no more than the hypothetical opinion of respondent's expert that the platforms at issue could, in fact, be relocated and reused or that there are locations for which the design specifications would be identical.

Respondent urges that the particular platforms at issue need not be salvageable if they are a type of asset that is ordinarily considered as having a salvage value. Petitioner has, however, amply demonstrated that, at time of acquisition, little, if any, salvage value was anticipated. The occasional incidents cited by respondent in which platforms were removed and reinstalled by entities other than Gulf were of a different type, in different depths of water and conditions, and reinstalled only after modifications. Further, the cited salvage operations occurred frequently as a result of unforeseeable disaster rather than being the routine type of salvage that occurs at the end of the ordinary useful life to the taxpayer. Sec. 1.167(a)-1, Income Tax Regs. "Ordinary" necessarily implies that salvage operations occur more frequently than extremely rarely. Respondent's evidence that decks belonging to unknown parties which may or may not have ever been installed as part of platforms were available for resale in years after the taxable years at issue does not persuade us to alter our conclusion that neither the platforms nor the major components thereof ordinarily have salvage value.

The evidence also establishes that the platforms, as a matter of economics, have no demonstrated salvage value at the end of their 20-year estimated life. Indeed, Gulf accrues an annual liability on its books to account for the estimated cost, in excess of scrap value, of dismantling and removing each platform at the end of its normal useful life. Gulf's actual experience confirms that the platforms do not have a salvage value. Moreover, as each platform is designed and constructed for use at a specific site, the evidence establishes that as a practical matter neither a platform nor its major components are salvageable. The hypothetical methods of salvage and reuse described by respondent's expert are not borne out by the experience of petitioner or by other owners of platforms in either the Gulf of Mexico or the North Sea.

More particularly, as specifically stated by respondent's expert, the hypothetical salvage value of the platforms totally ignores the economics of the situation. In practical terms, the decision to reuse a platform or its components is based upon an analysis of the cost of designing and developing a new platform or component versus reusing or modifying a salvage platform or component. Thus far, such analyses have shown that the salvage of the platforms or components presently in place is not economical as compared to merely scrapping the items. Further, even respondent's expert agreed that these platforms are designed for the particular conditions at a particular site, and that reuse would depend on finding a site with precisely the same conditions, an event not likely to occur.

We again point out that this opinion resolves certain severed issues only, and that all other issues not previously decided in this case,[4] are still before the Court.

We decide this issue for petitioner.

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[4] Other issues in this docket have been decided as follows: the "Worthless Properties" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 87 T.C. 135 (1986); the "Kuwait Nationalization" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 86 T.C. 937 (1986); the "Iranian Foreign Tax Credit" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 86 T.C. 115 (1986); the "North Sea Farmout" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 84 T.C. 447 (1985).

THE NORTHERN TRUST COMPANY, TRANSFEREE AND TRUSTEE; ARTHUR L. SIMON, TRANSFEREE AND TRUSTEE; AND JEFFERY J. SIMON, TRANSFEREE AND TRUSTEE, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 6859-80, 21439-80, 21440-80, 21441-80, 21442-80. Filed August 11, 1986.

In furtherance of an "estate tax freeze" plan, after a corporate reorganization J, W, P, L, and C transferred shares of class A voting common stock and class B nonvoting common stock of CCC, a closely held company, to certain long-term trusts. C died 3 days after transferring her shares. *Held*: The fair market value of the shares for Federal estate and gift tax purposes determined. The value was not affected by the transfer of the stock to the trusts. *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983); *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), applied.

William H. Pokorny, Jr., and *James A. Clark*, for the petitioners.

Thomas C. Borders and *Luanne D. Dimauro*, for the respondent.

NIMS, *Judge*: Respondent determined a deficiency of $154,683.45 in the Federal estate tax of petitioner, the Estate of Cecilia C. Simon.[2] Respondent determined the following deficiencies in other petitioners' Federal gift taxes:[3]

Docket No.	*Calendar quarter ending*	*Petitioner*	*Deficiency*
21439-80	June 30, 1976	John H. Curran	$131,777.60
21440-80	June 30, 1976	William Curran	131,777.60

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[1] Cases of the following petitioners are consolidated herewith: John H. Curran, docket No. 21439-80; William Curran, docket No. 21440-80; Patricia A. Curran, docket No. 21441-80; and Linda R. Curran, docket No. 21442-80.

[2] In the notice of deficiency issued to the Estate of Cecilia Simon, respondent determined a Federal estate tax deficiency of $184,388.90. On Feb. 20, 1985, respondent filed an amended answer in which he reduced the alleged estate tax deficiency from $184,388.90 to $154,683.45.

[3] John Curran and Linda Curran, husband and wife, and William Curran and Patricia Curran, husband and wife, made timely elections under sec. 2513(a) (gift by husband or wife to third party). Pursuant to sec. 2513(a), each gift is deemed to have been made one-half by the husband and one-half by the wife.

Docket No.	*Calendar quarter ending*	*Petitioner*	*Deficiency*
21441-80	June 30, 1976	Patricia A. Curran	$131,777.60
21442-80	June 30, 1976	Linda R. Curran	131,777.60

The issue for decision is the fair market value of 6 share of class A common voting stock and 2,300 shares of class nonvoting common stock of Curran Contracting Co. hel respectively by petitioners John Curran, William Curran and the Estate of Cecilia Simon on May 7, 1976 (see not 21).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found The stipulation of facts and attached exhibits are incorporated herein by this reference.

Cecilia Simon died a resident of Illinois on May 11, 1976 Petitioners John H. Curran and Linda Curran, husband an wife, and petitioners William Curran and Patricia Curran husband and wife, resided in Illinois at the time thei respective petitions were filed.

Petitioners John Curran (John) and William Curran (William), together with their sisters Cecilia Simon (Cecilia) an Judy Pokorny (Judy), were the sole shareholders of Curran Contracting Co. (CCC), a Delaware corporation engaged i the asphalt paving business. CCC had been incorporated i December 1975, as part of an overall plan of reorganizatio of several companies owned by members of the Curran family. The reorganization of the Curran family companie occurred as follows:

Prior to the incorporation of CCC, John, William, Cecilia and Judy, together with their cousin Henrietta Johnston (Henrietta), owned all of the issued and outstanding stock of Suburban Oil Co. (Suburban) and H.J. Curran Contracting Co. (HJCCC) as follows:

	Stock ownership	
Shareholder	*Suburban*	*HJCCC*
John	144 shares of voting common	148 shares of voting common
William	144 shares of voting common	148 shares of voting common

Shareholder	*Stock ownership*	
	Suburban	*HJCCC*
Cecilia	142 shares of voting common	146 shares of voting common
Judy	142 shares of voting common	146 shares of voting common
Henrietta	16 shares of voting common	3,520 shares of preferred

Suburban was the parent company directly or indirectly of Holland Co. (Holland) and Holland Railway Equipment, Ltd. (Holland, Ltd.). HJCCC was the parent company directly or indirectly of Stahl Construction Co. (Stahl), Curran Development Corp. (Curran Development), and Kaneland Construction Co. (Kaneland).

As the first step in a reorganization of the above companies, Suburban merged[4] with HJCCC. To effect this merger Suburban redeemed the 16 shares of Suburban common stock owned by Henrietta for $3,730 per share. The remaining shareholders then contributed their shares of Suburban common stock to HJCCC, where it was included in the paid-in capital surplus account of that company.

Subsequent to the merger of Suburban and HJCCC, HJCCC redeemed the 3,520 shares of HJCCC preferred stock owned by Henrietta for $30 per share. HJCCC then merged with CCC. Pursuant to the terms of the merger, John, William, Judy, and Cecilia received the following shares of CCC stock:

Shareholder	*Shares of stock owned*
John	6 shares class A voting common 2,300 shares class B nonvoting common 1,960 shares nonvoting preferred
William	6 shares class A voting common 2,300 shares class B nonvoting common 1,960 shares nonvoting preferred
Judy	6 shares class A voting common 2,300 shares class B nonvoting common 1,933 shares nonvoting preferred
Cecilia	6 shares class A voting common 2,300 shares class B nonvoting common 1,933 shares nonvoting preferred

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[4] The parties use the term "merger" in referring to the corporate combinations described herein, and we have accordingly, for convenience, adhered to that practice.

Each share of CCC preferred stock provided for a noncumulative dividend of $80. At the time of the reorganization, CCC had adequate earnings to pay these dividends. The Curran companies, however, had historically paid very small dividends and at the time of the reorganization, CCC's board of directors did not intend to pay dividends on CCC's preferred stock. The past and present management of CCC believed that profits should be reinvested in the business rather than paid out as dividends.

Moreover, the preferred shareholders of CCC could not compel the company to redeem their stock. The board of directors of CCC, however, could call the preferred stock at a charter specified redemption price of $1,000 per share. John and William intended to cause CCC to redeem their preferred shares at the time of their respective deaths for an amount that would produce sufficient income to pay the living expenses of their surviving spouses. They also intended to redeem the preferred shares owned by Cecilia and Judy at the time of each of their husband's deaths for an amount that would produce sufficient income to pay the living expenses of Cecilia and Judy. John and William did not intend to redeem the preferred stock for the stated price of $1,000 per share.

After the merger of CCC and HJCCC, John became CCC's president and chairman of its board of directors. William became CCC's vice president and a member of its board of directors. Jim Johnston, a cousin of John and William, served as CCC's secretary and as the third and final member of its board of directors.

As a result of the merger of HJCCC with CCC, CCC became the parent company directly or indirectly of Stahl, Kaneland, Suburban, Curran Development, Holland, and Holland, Ltd. These companies were engaged in the following businesses:

CCC, Stahl, and Kaneland were primarily engaged in the asphalt paving business. CCC performed most of its work in McHenry County, Illinois, which was the site of its asphalt production plant.[5] CCC received approximately 80 percent of its work from Federal, State and local governments. The remaining 20 percent of its work was done for larger commercial concerns.

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[5] Because of high transportation costs, CCC could competitively compete for jobs which were located no more than 30 to 35 miles from its asphalt production plant.

Stahl performed most of its work for Northern Illinois University located in DeKalb County, Illinois. DeKalb County was the site of Stahl's asphalt production plant. During the 1970s, Northern Illinois University was rapidly expanding. As of May 1976, this expansion was projected to continue through 1978.

Kaneland, which was located in Kane County, Illinois, had no access to an asphalt plant. Kaneland was therefore limited to performing "squirt work" in Kane County, which involved spraying oil on dusty gravel roads.

Suburban was engaged in the retail sale of heating oil to homeowners and commercial and industrial concerns located on the west side of Chicago and its western suburbs. During the early 1970s, Suburban's oil business sharply declined as gas replaced oil as the main energy source for residential and commercial heating. John and William therefore decided on or before May 7, 1976, to dispose of Suburban's retail fuel oil business and become fuel brokers. As fuel brokers, John and William intended to purchase oil from the major refineries and to hire independent truckers to deliver the oil to commercial and industrial concerns in retail quantities. As brokers, John and William would never take actual possession of the fuel.

Suburban also owned a parcel of investment property which was located in Oak Brook, Illinois. In 1974, Suburban entered into a contract to sell the property for $740,000. The purchaser subsequently paid an earnest money deposit of $40,000 but eventually defaulted on the contract.

Curran Development was formed in the 1970s to purchase and hold title to a parcel of land located adjacent to property that had been donated to the DeKalb YMCA. Stahl constructed roads on the acquired property to provide access to the donated property and to facilitate the development of the YMCA. As of May 7, 1976, approximately 50 percent of the parcel had been sold. The company had no plans to acquire or develop additional land.

Holland Co. was acquired by Suburban in 1974. The company consisted of the following divisions: (1) The rail weld division which manufactured equipment used for

welding rail on railroads and also provided welding services on a contract basis, and (2) the railroad equipment division which designed, patented, and sold products that extend the useful life of railroad cars and parts used by the railroad industry.

Holland, Ltd., was formed as a subsidiary of Holland for the sole purpose of allowing Holland to engage in business in Canada.

The consolidated balance sheet for CCC and subsidiaries on December 31, 1975, was as follows:

ASSETS	
Current assets	
Cash	$3,009,486
Accounts receivable, etc.	2,892,800
Inventories	762,710
Prepaid expenses and other current assets	156,808
Refundable income taxes	106,375
Total current assets	6,928,179
Other assets	
Notes receivable (long term)	12,384
Cash surrender value of life insurance (net)	213,112
Real estate investments	1,018,265
Total other assets	1,243,761
Deferred income taxes	14,000
Property, plant and equipment	3,584,974
Goodwill	642,248
Total assets	12,413,162
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities	
Accounts payable	1,380,195
Accrued liabilities	893,278
Other current liabilities	13,563
Current maturities (long-term debt)	635,820
Total current liabilities	2,922,856
Long-term debt	916,757
Other liabilities	29,000
Stockholders' equity	
Preferred stock ($10 par)	77,860
Class A voting common ($10 par)	240
Class B nonvoting common ($1 par)	9,200
Additional paid-in capital	1,409,379
Retained earnings	7,047,870
Total shareholders' equity	8,544,549
Total liabilities and shareholders' equity	12,413,162

The net sales and net earnings for CCC, Stahl, and Kaneland from 1971 through 1975 were as follows:

Year	*Net sales*	*Net earnings (before taxes)*
1971	$7,501,000	$1,150,000
1972	4,332,000	211,000
1973	5,912,000	1,252,000
1974	9,078,000	1,601,000
1975	11,363,000	2,308,000

The net sales and net earnings for Holland and its subsidiary, Holland, Ltd., from 1971 through 1975 were as follows:

Year	*Net sales*	*Net earnings (before taxes)*
1971	$4,418,000	$499,000
1972	4,341,000	544,000
1973	4,096,000	923,000
1974	5,745,000	897,000
1975 (11 mos.)	5,911,000	1,125,000

On May 7, 1976, John, William, Judy, and Cecilia each simultaneously created a trust (hereinafter referred to as a 76-1 trust) to which they transferred their respective, 6 shares of class A voting common stock of CCC. On the above date, John, William, and Cecilia also each created a second trust (hereinafter referred to as a 76-2 trust) to which they transferred their respective 2,300 shares of class B nonvoting common stock of CCC. All of the trusts were irrevocable after 20 days from the date of creation or the death of the grantor, whichever occurred first. The gifts of the class A voting common stock were made to place initial control of CCC in the hands of John and William, and to place eventual control of the company in the hands of their descendants. The gifts of the class B nonvoting common stock were primarily made to place any future appreciation of CCC in the hands of the grantors' descendants.

These gifts were made as part of petitioners' use of a familiar estate planning device known as an "estate tax freeze," by which the shareholders of a closely held corporation exchange their common stock in the corporation for new shares of common and preferred stock. (See *United States v. Byrum*, 408 U.S. 125 (1972).) The shareholders retain the preferred stock and make gifts of the common stock. Because the preferred stock does not usually participate in the future growth of the company, the value of the preferred shares is "frozen" as of the date of the reorganization. The shareholders intend that any future appreciation in the value of the company will be reflected in the value of the common stock.[6]

Each 76-1 voting common trust provided for the payment of net trust income to the descendants of the grantor. Each 76-2 nonvoting common trust provided for discretionary distribution of trust income and principal to the descendants of the grantor. Both types of trust provided for the distribution of all trust principal 21 years after the death of the last to die of: (1) The grantor, (2) the spouse of the grantor, (3) the grantor of each of the other trusts, (4) the spouses of the grantors of the other trusts, and (5) all of the descendants then living of John, William, Cecilia, and Judy. Each 76-2 trust contained a further provision prohibiting the trustee from making any transfer of CCC stock other than to: (1) A trust beneficiary in a partial or complete distribution upon termination of the trust, or (2) to CCC by way of a partial or complete redemption.

Each 76-1 trust named John and William as the initial trustees and gave to each of them the right to designate a successor trustee who would act when both John and William ceased to act. After the initial successor trustee ceased to act, successor trustees were thereafter to be appointed by the beneficiaries of the four 76-1 trusts.

Each 76-2 trust named the grantor's spouse as the initial trustee and gave such trustee the right, revocable while that trustee was still acting, to designate a successor trustee in the event that for any reason the initial trustee ceased to act. If and when the initial trustee and the designated successor trustee ceased to act, the children of each grantor were to act as co-trustees. Successor trustees were to be appointed thereafter by the grantor, or after the death of the grantor, by the beneficiary or a majority in interest of the beneficiaries to whom current trust income might then be distributed.

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[6] See G. Cooper, A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance 13-20 (Brookings Institution 1979); Ehrlich, "Corporate Recapitalization as an Estate Planning Business Retention Tool," 34 N.Y.U. Institute on Federal Taxation 1661, 1662-1669 (1976); and Burch & Hemmerling, "Estate Planning in an Inflationary Economy," 27 U.S.C. Tax Institute 489, 504-510 (1975).

Cecilia died on May 11, 1976. On February 4, 1977, CCC redeemed the shares of preferred stock held by the Estate of Cecilia Simon for $630 per share and the shares of class B common stock held by Cecilia's 76-2 trust for 63 cents per share. The redemption price was not the result of arm's-length bargaining, but rather represented an amount which John and William believed would generate sufficient income to pay the living expenses of Cecilia's husband.

On gift tax returns filed for the calendar quarter ending June 30, 1976, petitioners valued CCC's class A voting common stock at $10 per share and class B nonvoting common stock at $1 per share. On amended gift tax returns filed for the calendar quarter ending June 30, 1976, petitioners valued the voting common stock of CCC at $6.30 per share and the class B nonvoting common stock of CCC at 63 cents per share. The values listed on the amended gift tax returns were also assigned to the common stock of CCC on the Federal Estate Tax Return filed for the Estate of Cecilia Simon.[7]

In a notice of deficiency mailed to the Estate of Cecilia C. Simon, respondent valued the class A voting common stock of CCC at $205,000 per share. Respondent further determined that the class B nonvoting common stock of CCC had no value.

In separate notices of deficiency mailed to John Curran, Linda Curran, William Curran, and Patricia Curran, respondent valued CCC's class A voting common stock and class B nonvoting common stock at $534.02 per share.

At trial, the Court received testimony with respect to the valuation of CCC's class A voting common stock and its class B nonvoting common stock from petitioners' expert, Roger J. Grabowski, and respondent's expert, Eugene M. Lerner. Grabowski valued the class A common shares at $470.33 per share and the class B common shares at $58.80 per share. Lerner valued both the class A common shares and the class B common shares at $454.99 per share. B amended answer filed subsequent to the trial of this cas respondent stated that the May 7, 1976, value of the clas A and class B common stock held by the Estate of Cecili C. Simon was $454.99 per share.

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[7] The value of Cecilia's common stock was includable in her gross estate under sec. 2035(a) as a gift made in contemplation of death.

All section references are to sections of the Internal Revenue Code of 1954 in effect on the valuation date applicable to Mrs. Simon's estate or the date of the respective gifts, as the case may be.

The valuations placed on the two classes of common stoc by the experts are reflected in the following table:

	Class A common			*Class B common*		
Appraiser	*Shares*	*Value*	*Total*	*Shares*	*Value*	*Total*
Grabowski	24	$470.33	$11,287.92	9,200	$58.80	$540,960
Lerner	24	454.99	10,919.76	9,200	454.99	4,185,908

Thus, petitioners' expert valued the entire common stoc at $552,247.92, while respondent's expert valued it a $4,196,827.70, the basic difference resulting from petitioners' deep discount of the class B common. The appropriateness of this discount is the essential focal point of this cas

Grabowski Appraisal

Roger J. Grabowski is a partner and co-founder o Valuation Strategies, a firm specializing in the valuation o closely held businesses and intangible assets. Petitioner retained Grabowski to value CCC's class A voting commo stock and class B nonvoting common stock. Grabowsk used two methods to value these stocks: (1) The marke comparable approach, and (2) the discounted cash flo approach.

Market Comparable Approach

Using the market comparable approach, Grabowski se out to estimate the value of CCC by comparing it to publicl traded companies engaged in the same or similar lines o businesses as that of CCC and its subsidiaries. Because h was unable to find publicly traded companies which wer engaged in the asphalt paving business, the rail welding business, and the heating oil distribution business Grabowski divided CCC into its operational components an looked for publicly traded companies engaged in the sam business as each component. He grouped CCC, Stahl, an Kaneland together and treated them as one compan engaged in the asphalt paving business (we will hereinafte refer to CCC, Stahl, and Kaneland as C/S/K for purposes of our discussion of Grabowski's valuation). He treated Holland (including its subsidiary, Holland, Ltd.) as a separate company engaged in the railroad equipment business. Finally, he separately valued Suburban and the other nonoperating assets owned by CCC and its subsidiaries.

Valuation of C/S/K

Grabowski discovered three publicly traded companies that he believed were engaged in businesses that were subject to the same economic conditions as the road construction business of C/S/K. These companies were: (1) McDowell Enterprises, Inc., (2) Rexco Industries, and (3) Sukut Construction, Inc.

McDowell Enterprises, Inc., located in Nashville, Tennessee, was engaged in diversified construction, including highway construction and real estate development. The company was also engaged in the development of material supply throughout the southeastern United States. In 1975, its revenues totaled $55 million.

Rexco Industries, located in Puerto Rico, was primarily engaged in the construction of highways, bridges, hospitals, commercial buildings, industrial plants, and residential buildings. Its revenues totaled $56 million in 1975.

Sukut was a general contracting firm engaged in the construction of sites for residential, commercial, industrial, and recreational developments and in the construction of roads, highways, and public works. Sukut performed most of its work in southern California. In 1975, its revenues totaled approximately $8 million.

Having identified three publicly traded comparable companies, Grabowski next computed certain market multiples based on the comparable companies' earnings before deductions for interest, depreciation, and taxes (EBIDT) and debt-free cash-flow (DFCF).[8] Dividing the sum of the aggregate market value of the capital stock and long-term debt of each comparable company by its respective EBIDT and

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[8] Grabowski defined debt-free cash-flow as the cash-flow generated by the operations of the company (net earnings plus non-cash expenses such as depreciation) adjusted to a debt free basis by adding back the after tax cost of interest.

DFCF, Grabowski developed the following market multiples for the comparable firms:

Firm	Market value	EBIDT	EBIDT multiple	DFCF	DFCF multiple
McDowell	$19,106,000	$6,121,000	3.12	$4,381,000	4.36
Rexco	18,894,000	4,631,000	4.08	4,073,000	4.64
Sukut	1,166,000	578,000	2.02	455,000	2.56

Grabowski next computed C/S/K's EBIDT and DFCF. Relying on C/S/K's weighted earnings for the 5-year period preceding the valuation date, Grabowski determined that C/S/K had EBIDT of $1,929,000 and DFCF of $1,174,000. Applying the above market multiples to C/S/K's EBIDT and DFCF, Grabowski preliminarily valued C/S/K at $5 million.

Grabowski next adjusted the market multiples to account for the differences in size between C/S/K and the comparable firms. To make these adjustments, Grabowski relied on an Internal Revenue Service study which listed average price/earnings ratios for companies traded on the New York Stock Exchange according to their fair market value. Based on this study, Grabowski concluded that publicly traded companies with values equal to C/S/K had average price/earnings ratios of 10.10. He further determined that publicly traded companies with values equal to McDowell and Rexco had average price/earnings ratios of 11.35. He finally concluded that companies with values equal to Sukut had average price/earnings ratios of 12.26. Based on these relative price/earnings ratios, Grabowski determined the following percentages to account for the market's reaction to the differences in size between C/S/K and the comparable firms:

Comparable	Factor
McDowell and Rexco	10.10/11.35 = .89
Sukut..	10.10/12.26 = .824

Grabowski next weighted each market multiple based on the relative similarity of each comparable company to C/S/K. Finally, applying the market multiples as adjusted to C/S/K's EBIDT and DFCF, Grabowski valued C/S/K at $5,884,000 and $4,479,000, respectively, as follows:

	EBIDT MULTIPLE				*DFCF MULTIPLE*			
	Adjustment			*Adjustment*	*Adjustment*			*Adjustment*
Firm	*Multiple*	*for Size*	*Weight*	*multiple*	*Multiple*	*for Size*	*Weight*	*multiple*
McDowell	3.12	x .89	x .45 =	1.2496	4.36	x .89	x .45 =	1.7462
Rexco	4.08	x .89	x .45 =	1.6340	4.64	x .89	x .45 =	1.8583
Sukut	2.02	x .824	x .10 =	.1665	2.56	x .824	x .10 =	.2109
				3.0501				3.8154
				x $1,929,000 (EBIDT)				x $1,174,000 (DFCF)
Indicated value		=		$5,884,000 (rounded)		=		$4,479,000 (rounded)

Taking an average of these two values, Grabowski valued C/S/K at $5,181,000 as of May 7, 1976.[9]

Holland Co.

Grabowski selected six publicly traded companies which he believed were subject to the cyclical nature of the railroad industry and thus comparable to Holland (including its subsidiary, Holland, Ltd.). These companies were: (1) Amsted Industries, (2) Brenco, (3) Portec, (4) General Signal, (5) Pittsburgh Forgings, and (6) Stanray.

Amsted Industries was engaged in numerous businesses, including the manufacture of component parts for railroad cars.[10] These components consisted of side frames and bolsters (commonly known as trucks), couplers, springs, yokes, brake beams, springs, steel railroad wheels, brake shoes for railroad cars and locomotives, and brass journal bearings. Its revenues totaled $489 million in 1975.

Brenco manufactured and serviced roller bearings and bronze bearings for railroad cars and other industrial markets. Its revenues totaled $43 million in 1975.

Portec designed, manufactured, and sold products for transportation and industrial markets, including rail anchors and lubricators and rail car auto shipping racks. It had sales of $107 million in 1975.

General Signal produced cabs, wayside, and centralized traffic control components and systems, pushbutton interlocking controls, operational display subsystems, and other control systems for railroads. It also engaged in numerous other businesses.[11] The company's sales totaled $547 million in 1975.

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[9] We note that the average of $5,884,000 and $4,479,000 is $5,181,500 rather than $5,181,000.

[10] The record does not disclose the other businesses engaged in by Amsted Industries.

[11] The record does not disclose the other businesses engaged in by General Signal.

Pittsburgh Forgings Co. was engaged in (1) the construction and repair of railroad freight cars, and (2) the castings business. Its sales totaled $179 million in 1975.

Stanray Corp. manufactured metal roofs, coupling devices, wheel truing machines, and other items and equipment for use in the construction, repair, and rebuilding of railroad cars. The company was also engaged in various other businesses.[12] Its sales totaled $75 million in 1975.

Following the same approach as described above, Grabowski developed market multiples based upon the EBIDT and debt-free cash-flow of the comparable firms. Applying these market multiples to Holland's EBIDT and DFCF, Grabowski valued Holland at $4,024,000 and $4,777,000, respectively. Grabowski's calculations may be summarized as follows:

	EBIDT MULTIPLE		*DFCF MULTIPLE*	
Firm	*Multiple* x *Adjustment for Size* x *Weight*	*Adjustment multiple*	*Multiple* x *Adjustment for Size* x *Weight*	*Adjustment multiple*
Amsted	3.44 x .635 x .15 =	.3277	5.77 x .635 x .15 =	.5496
Brenco	5.98 x .735 x .20 =	.8791	10.18 x .735 x .20 =	1.4965
Portec	4.63 x .859 x .20 =	.7954	7.63 x .859 x .20 =	1.31083
General Signal	4.50 x .635 x .15 =	.4286	11.68 x .635 x .15 =	1.1125
Pittsburgh Forging	4.50 x .735 x .20 =	.6615	7.31 x .735 x .20 =	1.0746
Stanray	2.81 x .890 x .10 =	.2501	4.80 x .890 x .10 =	.4272
		3.3424		5.97123
	x	$1,204,000 (EBIDT)	x	$800,000 (DFCF)
	Indicated Value x	$4,024,000 (rounded)	=	$4,777,000 (rounded)

Grabowski averaged these values to arrive at an indicated rounded value of $4,400,000 for Holland.

Remaining Subsidiaries

As of the date of the gifts in issue, the board of directors of CCC had decided to dispose of Suburban's retail fuel oil business and have Suburban become a fuel broker. Grabowski therefore determined that Suburban's liquidation value was the most accurate estimate of Suburban's value as of the date of the gifts. Grabowski estimated the liquidation value of Suburban (net of estimated corporate taxes due on sale and estimated costs of sale including holding costs) as follows:

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[12] The record does not disclose the other businesses engaged in by Stanray Corp.

Excess of current assets over current liabilities	$1,100,000
Equipment	20,000
Land and buildings in Forest Park (3 buildings and 1 vacant parcel)	325,000
Retail home heating oil customer list	25,000
Land in Oak Brook, Illinois	780,000
Total	2,250,000

Grabowski estimated the liquidation value of certain other nonoperating assets owned by CCC as follows:

Farmland in Crystal Lake	$175,000
Land owned by Curran Development	240,000
Total	415,000

To the above liquidation values, Grabowski added an amount representing the value of CCC's net working capital.[13] Grabowski valued CCC's net working capital as of May 7, 1976, at $400,000.

Because the gifts in issue represented minority interests in CCC, Grabowski reduced the value of CCC's net working capital and the asset liquidation value of its nonoperating assets by a minority position discount of 35 percent.[14] Grabowski based this discount factor on a study conducted by Douglas Austin which found that in successful cash tender offers occurring during the period 1972 through 1975, investors paid an average premium of 35.75 percent for stock which represented a controlling interest in a company. Based on a minority discount factor of 35 percent, Grabowski determined a minority position equivalent value of $2,270,000 (($400,000 plus $2,665,000) divided by 1.35) for Suburban and the other nonoperating assets of CCC.

Grabowski combined the above values he determined for C/S/K, Holland, Suburban, and the other nonoperating assets owned by CCC and its subsidiaries to arrive at a total value of $11,851,000 for CCC's long-term capital debt, preferred stock, and total common equity. To determine the value of CCC's total common equity, Grabowski reduced the above value by $1,339,000, the amount of CCC's outstandin long-term debt as of May 7, 1976, and by $4,983,040, th intrinsic value of CCC's preferred stock as of the valuatio date.

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[13] Grabowski defined net working capital as the amount of cash which could be removed from the businesses without impairing their operations.

[14] Grabowski did not apply a minority position discount to the values determined for C/S/K and Holland because the market prices of the common stock of the comparable firms used to compute the market multiples represent minority positions in those companies.

To value the outstanding shares of CCC's preferred stoc Grabowski looked to the average dividend yield for th following publicly traded preferred stocks as listed i Moody's Preferred Stock Yield Averages for May 1976:

Stock	*Yield*
High grade industrials	7.59 percent
Medium grade industrials	7.86 percent
Speculative grade industrials	8.48 percent

Based on these yields, Grabowski concluded that a reaso able yield for the preferred stock of CCC would be 12. percent, pointing out that while CCC's preferred dividend were noncumulative, the company had sufficient resourc to pay preferred dividends without impairing ongoing bus ness operations. Based on a dividend yield of 12.5 percent Grabowski valued the 7,786 outstanding shares of CC preferred stock at $4,983,040, or $640 per share.[15]

Subtracting $1,339,000, the amount of CCC's outstandin long-term debt, and $4,983,040, the value of CCC's issue and outstanding shares of preferred stock, fro $11,851,000, the total value of CCC and its subsidiarie Grabowski determined a value of $5,528,960 for CCC's tota common equity.[16]

Discounted Cash-Flow Approach

Grabowski used a second method to value the commo stock of CCC. Under this second approach, Grabowsk valued Suburban and CCC's other nonoperating assets usin their previously determined liquidation values. Grabowsk however, used the discounted cash-flow approach to valu

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[15] We note that in his valuation report, Grabowski stated that "To determine the Fa Market Value of the preferred stock one needs to reduce this amount by a discount for lack o marketability." In determining the market value of CCC's preferred stock, howeve Grabowski did not discount its intrinsic value for lack of marketability. On brief, petitione maintain that a discount of 20 percent for lack of marketability would have been appropria Based on a 20-percent discount, the value of CCC's preferred stock would be $3,986,432, o $512 per share.

[16] We note that had Grabowski valued CCC's preferred stock at $3,986,432, rather th $4,983,040, the value of CCC's total common equity would have been $6,525,568, rather th $5,528,960.

C/S/K and Holland. This valuation method is based on the assumption that the price an investor will pay for a share of stock is the present value of the future stream of income he expects to receive from the investment.

Under the discounted cash-flow approach, Grabowski determined a present value equivalent for: (1) The amount of cash that C/S/K and Holland could pay to their shareholders over a 10-year period without impairing business operations (we will hereinafter refer to this amount as available cash-flow),[17] and (2) the companies' residual value at the end of 10 years. Adding these two values together, Grabowski determined a second value for the common shareholders' equity in C/S/K and Holland.

In computing C/S/K's projected 10-year cash-flow, Grabowski estimated that C/S/K's 1976 revenues would be 15 percent less than its 1975 revenues. He based this projection on C/S/K's sales experience for the first 4 months of 1976. Relying on C/S/K's average revenue trend for the period 1970 through 1975, Grabowski projected that C/S/K's net sales would increase 5 percent in each of the years 1977 through 1980 and 2 percent in each of the years 1981 through 1985. Grabowski estimated C/S/K's expenses for the 10-year period as a percentage of projected sales. These percentages were based on average trends experienced by C/S/K in prior years.

Grabowski projected that Holland's 1976 revenues would be 30 percent greater than its 1975 revenues. He based this projection on Holland's sales experience for the first 4 months of 1976. Grabowski attributed this increase in sales to favorable provisions contained in the Railroad Revitalization and Regulatory Reform Act of 1976 which encouraged railroads to upgrade their track. Grabowski believed that these provisions would continue to benefit Holland's business in the future and therefore projected that Holland's net sales would increase 20 percent in 1977, 15 percent in 1978 and 1979, 10 percent each year from 1980 through 1982, and 8 percent per year from 1983 through 1985. As with C/S/K, Grabowski estimated Holland's expenses for the 10-year period as a percentage of its projected sales. These percentages were based on average trends experienced by Holland in prior years. The table on page 367 summarizes Grabowski's computation of C/S/K's and Holland's available cash-flow:

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[17] Grabowski defined available cash-flow as: (1) Net income after taxes *plus* (2) depreciation/amortization *minus* (3) increases in net working capital needed to support sales *minus* (4) capital expenditures *minus* (5) repayments of principal on long-term debts *minus* (6) preferred stock dividends. In his actual computations of available cash-flow, Grabowski also made an addition and a reduction in net working capital for certain years. See table summarizing Grabowski's computation *infra*.

To determine a present value equivalent for these 10-year projected cash-flows, Grabowski was required to determine an appropriate discount rate. He used the following formula to arrive at the appropriate discount rate:

$$K = R_f + \text{Beta}\ (R_1) + R_2$$

K = cost of equity capital

R_f = current market rate on U.S. Government bonds

R_1 = premium an investor would expect before he would invest in common stock rather than U.S. Government bonds

Beta = relationship between the movement of stock prices for companies engaged in specific industries (i.e., construction business, and railroad supply business) and the movement of stock prices in general

R_2 = additional premium an investor would expect before he would invest in the common stock of C/S/K and Holland

Grabowski determined that in May 1976, the current market yield on 10-year U.S. Government bonds was 6.96 percent. To this figure he added a risk premium which represented the additional return an investor would require before he would invest in common stocks of publicly traded companies engaged in the construction business and railroad supply business rather than U.S. Government securities. To determine this premium, Grabowski first determined that an investor would require an additional return of 6 to 8 percent before he would invest in common stocks in general, rather than U.S. Government securities. Grabowski based this figure on studies which found that investors in diversified portfolios of common stocks trading on the New York Stock Exchange realized yields which were 6 percent to 8 percent larger than yields on long-term U.S. Government securities. Grabowski then multiplied this risk pre

($000)

	1976 (8 mos.)	1977	1978	1979	1980	1981	1982	1983	1984	1985
Operating income										
CCC/Stahl/Kaneland	$2,457	$1,875	$1,800	$1,900	$1,870	$1,670	$1,700	$1,740	$1,770	$1,810
Holland	1,557	1,850	2,130	2,720	2,990	3,290	3,620	3,910	4,220	4,560
Total	4,014	3,725	3,930	4,620	4,860	4,960	5,320	5,650	5,990	6,370
Less: Interest expense	33	90	70	...	...	...	...	...	...	...
Equals: Pre-tax income	3,981	3,635	3,860	4,620	4,860	4,960	5,320	5,650	5,990	6,370
Less: Income taxes	1,913	1,685	1,780	2,150	2,250	2,290	2,450	2,600	2,760	2,930
Plus: Depreciation										
CCC/Stahl/Kaneland	272	405	425	445	470	475	485	495	505	515
Holland	315	500	570	660	730	800	880	955	1,030	1,110
Less: Increases in net working capital										
CCC/Stahl/Kaneland	(250)	70	80	85	35	35	35	35	35	40
Holland	200	170	150	180	130	150	160	150	160	165
Less: Capital expense										
CCC/Stahl/Kaneland	430	460	480	500	530	540	550	560	570	580
Holland	690	1,000	1,160	1,330	1,460	1,610	1,770	1,910	2,060	2,230
Less: Principal payments on debt	430	635	275	...	...	...	...	...	...	...
Equals: Cash-flow before preferred dividends	1,155	520	930	1,480	1,655	1,610	1,720	1,845	1,940	2,050
Less: Preferred dividends	622	622	622	622	622	622	622	622	622	622
Plus: Reductions in net working capital	...	(102)	...	500	...	...	...	...	...	...
Equals: Available cash-flow	533	0	308	1,358	1,033	988	1,098	1,223	1,318	1,428

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mium by a "beta coefficient" which represented the relationship between the movement of stock prices for publicly traded companies engaged in the construction business and the railroad supply business and the movement of stock prices in general. Based on a sample of common stock of publicly traded companies engaged in construction, Grabowski estimated that such stocks had a beta of 1.3 (i.e., when stock prices in general increase or decrease 10 percent, the stock prices for publicly traded companies engaged in construction increase or decrease 30 percent). Based on a sample of common stocks of publicly traded companies engaged in the railroad supply business, Grabowski determined that such stocks had a beta of .95 (i.e., when stock prices in general increase or decrease by 10 percent, the stock prices for publicly traded companies engaged in the railroad supply business increase or decrease 9.5 percent).

Finally, Grabowski added a risk premium to reflect the additional return an investor would require before he would choose to invest in the common stock of an unlisted company similar to C/S/K and Holland. He determined that a risk premium of 3 percent to 6 percent would be appropriate for Holland and a risk premium of 4 percent to 7 percent would be appropriate for C/S/K.

Applying the formula $K = R_f + \text{Beta}\,(R_1) + R_2$ to the above variables, Grabowski determined that an investor would require an expected average return of 21 percent on an investment in the common stock of C/S/K and Holland before he would decide to make such an investment. Grabowski applied the formula as follows:

C/S/K: $K = 6.96\% + 1.3\,(6\%\text{-}8\%) + (4\%\text{-}7\%)$
Holland: $K = 6.96\% + .95\,(6\%\text{-}8\%) + (3\%\text{-}6\%)$

Based on a discount factor of 21 percent, Grabowski determined a present value equivalent of $3,159,000 for the 10-year projected cash-flows as follows:

	($000)				
	1976 (8 mos.)	*1977*	*1978*	*1979*	*1980*
Cash-flow	533	0	308	1,358	1,033
PV Factor at 21%	.8807	.7278	.6015	.4971	.4108
Present value	469	0	185	675	424

($000)

	1981	*1982*	*1983*	*1984*	*1985*	*Total*
Cash-flow	988	1,098	1,223	1,318	1,428	
PV Factor at 21%	.3395	.2806	.2319	.1917	.1584	
Present value	335	308	284	253	226	3,159

Having determined the present value of the 10-year projected cash-flows for C/S/K and Holland, Grabowski next determined the present value of the companies' residual values at the end of 10 years. Estimating that future available cash-flows would grow approximately 4 percent per year after 1985 and applying a 21-percent discount factor, Grabowski determined a present value of $1,331,000 for the residual value of C/S/K and Holland at the end of 10 years.

To determine the total value of the common shareholders' equity, Grabowski added together the values he determined for C/S/K and Holland using the discounted cash-flow approach and the previously determined liquidation values of Suburban and the other nonoperating assets owned by CCC. Based on the sum of these values, Grabowski valued CCC's common shareholders' equity at $7,155,000.

Grabowski next discounted the above value by 35 percent to reflect the fact that the gifts in issue represented minority positions in CCC. Applying this minority discount factor to the above value, Grabowski determined a final value of $5,300,000 for CCC and its subsidiaries under the discounted cash-flow approach.

Grabowski averaged CCC's market comparable value (rounded to $5,529,000) and discounted cash-flow value ($5,300,000) to arrive at a final value of $5,425,000 for CCC's total common equity.[18]

Allocation of Common Shareholders' Equity Among Class A Voting Shares and Class B Nonvoting Shares

Having determined a total value of $5,425,000 for CCC's common shareholders' equity, Grabowski next determined that this amount should be allocated pro rata among CCC's outstanding shares of common stock, concluding that each share of class B nonvoting common was equal in value to each share of class A voting common. Grabowski based this conclusion on the fact that the holder of a minority interest in CCC's class A voting common stock would not possess voting control and therefore could not affect the company's dividend policies. Grabowski therefore believed that the class A shareholders would receive the same dividends per share as the class B shareholders in the event CCC paid common dividends. Grabowski thus valued the 24 shares of the class A voting common stock at $14,105 ($588 per share), which represented .26 percent of CCC's total common equity. Similarly, he valued the 9,200 shares of class B nonvoting common at $5,410,895 ($588 per share), which represented 99.74 percent of CCC's total common equity.[19]

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[18] We note that had Grabowski valued CCC's common equity at $6,525,568 using the market comparable approach, the average value for CCC's common equity would be $5,912,784.

Discount for Lack of Marketability

Grabowski next discounted the indicated stock values for lack of marketability. With respect to the class A common shares, Grabowski applied a discount of 20 percent for lack of marketability. In determining the appropriate discount rate, Grabowski noted that an investor could purchase 6 shares of CCC's class A common stock for a relatively small sum of money ($3,528). He also pointed out that an investor would be aware of CCC's ability to pay dividends to its common shareholders. On the other hand, Grabowski emphasized that an investor would know that the management of CCC did not intend to pay dividends and that the remaining 18 shares of class A common stock were held in trusts which placed control of the company in CCC's present management and their appointed successors for many years in the future.

Grabowski reduced the value of CCC's class B common stock by a 90-percent discount for lack of marketability. Grabowski based this large discount on the fact that an investor would be required to pay $1,352,400 to acquire a block of 2,300 shares of class B common stock at a price of $588 per share. Grabowski concluded that an investor would not pay more than $135,240 for such shares given the small probability that the management of CCC would decide to pay common dividends, to redeem the stock, or to liquidate the corporation.

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[19] The aggregate values of the class A and class B common stock were rounded by Grabowski. We also note that had Grabowski valued CCC's common equity at $5,912,784, the value of each share of CCC common stock would have been $641.

Consequently, based on the analysis described above, Grabowski valued each block of 6 shares of CCC class A voting common stock at $2,822, or $470.33 per share, and each block of 2,300 shares of CCC class B nonvoting common stock at $135,240, or $58.80 per share.

Lerner Appraisal

Eugene M. Lerner is a Professor of Finance in the Graduate School of Management at Northwestern University. He was retained by respondent to value the class A and class B common stock of CCC at issue in this case.

Market Comparable Approach

Lerner first valued CCC using a market comparable approach. He initially searched for publicly traded companies engaged in the asphalt paving business, the rail welding business, and the heating oil distribution business. However, because he was unable to locate individual companies engaged in all three businesses, Lerner looked for publicly traded companies with similar financial characteristics as CCC.

Lerner determined that during the period 1971 through 1975, CCC had a return on equity of 15.56 percent, sales of approximately $20 million per year, and a debt/equity ratio of 45 percent. Using Compustat, a computer program containing the financial data of approximately 2,500 publicly traded companies, Lerner searched for companies with returns on equity ranging from 12 percent to 17 percent, sales of less than $25 million, and debt/equity ratios of less than 70 percent. Lerner discovered 17 publicly traded companies meeting all three financial criteria.

Lerner next computed the price/earnings ratio, the price/book value ratio, and the dividend/price ratio for each comparable company. The averages for these ratios are set forth below:

Ratio	*Average*
Price/earnings	7.9
Price/book value	1.075
Dividend/price	3.6%

Based on these ratios, Lerner valued CCC as follows:

Year	*Income*	*Weight*	*Weighted income*
1971	$838,054	1	$838,054
1972	306,749	2	613,498
1973	1,176,537	3	3,529,611
1974	1,414,801	4	5,659,204
1975	1,861,085	5	9,305,425
	5,597,085	15	19,945,792
Weighted income			$1,329,719

Based on weighted income of $1,329,719 and a price/ear ings ratio of 7.9, Lerner valued CCC at $10,504,780.

Lerner next computed a book value of $8,544,549 for CC Based on a comparable price/book ratio of 1.075, Lern valued CCC at $9,185,390.

As a result of its strong financial condition, Lern estimated that CCC could have paid annual dividends $438,807 (33 percent of weighted earnings of $1,329,71 Based on a dividend/price ratio of 3.6 percent, Lerner value CCC at $12,190,058.

Using a weighted average of the above values, Lern determined a final value of $10,211,521 for CCC and i subsidiaries as follows:

Ratio	*Valuation*	*Weight*[20]	*Weighted valuati*
Price/earnings	$10,504,780	55	$5,777,629
Price/book value	9,185,390	35	3,214,886
Dividend/price	12,190,058	10	1,219,000
			10,211,515

Second Valuation Method

In addition to valuing CCC as one consolidated compan Lerner also separately valued CCC's operational componen (i.e., the paving companies, Suburban, and Holland). I used the market comparable approach described above value the three paving companies. He relied on Suburba book value as a fair indication of that company's market value. Finally, Lerner valued Holland based on the sum of its 1974 purchase price and the company's post-acquisition earnings. Lerner's computations may be summarized as follows:

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[20] In determining the appropriate weight to assign to each value, Lerner concluded t investors, aware that CCC's management had historically paid low dividends, would h placed less emphasis on CCC's dividend/price ratio and more emphasis on its price/earni ratio and price/book value ratio.

Paving Companies

Ratio	*Factors*	*Amount*	*Valuation*	*Weight*	*Weighted valuation*
Price/earnings	7.69	$813,997	$6,259,637	55	$3,442,800
Price/book value	.971	6,668,805	6,475,410	35	2,266,394
Dividend/price	4%	268,619	6,715,475	10	671,548
					6,380,742
Suburban book value					1,625,095
Holland					
1974 purchase price		$2,887,300			
Post-acquisition earnings		703,449			3,590,749
Total value		3,590,749			11,596,586

Valuation of CCC's Common Equity

Having valued CCC at $10,211,515 using the market comparable approach and having valued CCC at $11,596,586 using a combination of several different valuation methods, Lerner averaged these two values to arrive at a final value of $10,904,054 for CCC and its subsidiaries. To determine the value of CCC's common equity, Lerner subtracted $4,447,363, the value of CCC's preferred stock, from the company's overall value of $10,904,054.

To value the preferred stock of CCC, Lerner looked to the return an investor could realize on the following alternative investments:

Investment	*Rate of return*
U.S. Treasury securities	
3 years	7.49%
10 years	7.99
Corporate bonds	
AAA	8.83
BAA	10.61
Medium grade industrials	8.58

Based on the yield of these alternative investments and recognizing that an investor would perceive some additional risk in investing in the preferred stock of CCC, Lerner conservatively concluded that a potential investor would expect a return of at least 14 percent on the amount of cash he would be required to invest to purchase CCC's preferred stock. Based on a 14-percent dividend yield and assuming that CCC's preferred stock would pay its stated dividend of $80 per share, Lerner valued the preferred stock of CCC at $4,447,363 or $571.20 per share. Subtracting this amount from his aggregate valuation of CCC, Lerner valued CCC's common equity at $6,456,691.

Lerner next allocated the value of CCC's common equity pro rata among the class A voting common stock and the class B nonvoting common stock. As did petitioners' expert, Lerner determined that each share of class A common stock was equal in value to each share of class B common stock. He therefore valued the 24 issued and outstanding shares of class A voting stock and the 9,200 issued and outstanding shares of class B nonvoting stock at $699.99 per share.

Minority Discount and Discount for Lack of Marketability

Finally, Lerner reduced the value of each share of common stock by a minority discount of 15 percent and a discount of 20 percent for lack of marketability. In determining the appropriate discounts, Lerner considered the fact that the stock of small, closely held corporations is generally difficult to sell. He believed, however, that this negative factor would be substantially offset by a potential buyer's awareness that CCC was a financially strong old-line company with excellent and aggressive management and the capacity to pay dividends. After applying a minority discount and a discount for lack of marketability, Lerner determined a final fair market value of $454.99 for each share of CCC common stock.

OPINION

At issue in this case is the value for gift tax purposes of CCC's class A and class B common stock held by John Curran and William Curran on May 27, 1976,[21] the date of the gifts in issue and the value for estate tax purposes of CCC's class A and class B common stock held by Cecilia Simon on May 11, 1976. the date of her death.

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[21] On brief, both petitioners and respondent treat the appropriate valuation date as May 1976, the date on which the trusts in issue were created. These trusts, however, were revocable until the earlier of May 27, 1976, or the death of the grantor. Consequently, the gifts were not complete for Federal gift tax purposes until May 27, 1976, when the trusts became irrevocable. Sec. 25.2511-2(c), Gift Tax Regs.

Under section 2035(a), the value of the gross estate includes (with certain exceptions not here applicable) the value of all property transferred by the decedent within 3 years of death. Since the executor of Mrs. Simon's estate did not elect alternative valuation under section 2032, the date of death (May 11, 1976) value applies as to the stock in her estate. Under section 2512(a), the value of property for gift tax purposes is determined on the date of the gift.

For both estate and gift tax purposes, fair market value is defined as "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Sec. 20.2031-1(b), Estate Tax Regs.; sec. 25.2512-1, Gift Tax Regs. The valuation of stock presents a question of fact, and the trier of fact has the duty to weigh all relevant evidence and to draw appropriate inferences therefrom. *Hamm v. Commissioner*, 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo. 1961-347.

Section 20.2031-2(f), Estate Tax Regs., and section 25.2512-2(f), Gift Tax Regs., set forth some of the relevant factors to be considered in determining the value of stock in a closely held corporation in the absence of actual sales prices and bona fide bid and asked prices. Those factors include the company's net worth, prospective earning power, dividend-paying capacity, and other relevant factors. The regulation states that "other relevant factors" include:

> the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. * * *

At trial, petitioners and respondent each presented the testimony of an expert to establish the value of CCC's common stock. Petitioners' expert valued CCC's class A voting common stock at $470.33 per share, and CCC's class B nonvoting common stock at $58.80 per share. Respondent's expert valued both the class A and class B stock at $454.99 per share. We recognize that expert testimony is peculiarly appropriate in cases dealing with the value of stock of unlisted, closely held corporations. *Central Trust Co. v. United States*, 158 Ct. Cl. 504 (1962), 305 F.2d 393. Nevertheless, for the reasons stated below, we do not fully agree with either expert's valuation determination.

To summarize briefly, petitioners' expert, Grabowski, relied on the market comparable approach and the discounted cash-flow approach to value CCC, Stahl, Kaneland, and Holland. He relied on the liquidation values of the remaining subsidiaries as evidence of their intrinsic values. Respondent's expert, Lerner, used a modified market comparable approach to value CCC and its subsidiaries as one consolidated company as well as to individually value CCC, Stahl, and Kaneland. After valuing CCC, Stahl, and Kaneland by using a modified market comparable approach, Lerner valued Suburban based on its book value and Holland based on its 1974 purchase price increased by its post-acquisition earnings.

First, we cannot accept Grabowski's market comparable valuation of CCC, Stahl, Kaneland, and Holland. Section 2031(b) provides that "the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange" is a factor to be considered in valuing the stock of an unlisted corporation. In valuing CCC, Stahl, and Kaneland, Grabowski relied on market multiples based on the financial statistics of McDowell, Rexco, and Sukut, publicly traded companies engaged in the construction of highways, residential buildings, commercial buildings, and industrial plants. CCC, Stahl, and Kaneland, however, were Illinois companies engaged solely in the asphalt paving business. If the "other relevant factors" concept of section 20.2031-2(f) is to be meaningfully applied, then companies engaged in diversified construction are not sufficiently similar to companies engaged solely in asphalt paving to provide reliable comparisons for valuation purposes. This is particularly true in the instant case since the record contains no evidence of the percentage of revenues earned by the comparable companies from highway construction. Such revenues may be insignificant in relation to the total revenues of the companies compared.

We also point out that Grabowski's expert report shows that sales for CCC, Stahl, and Kaneland increased 21 percent per year during the period 1971 through 1975, while sales for the comparable companies increased only 5 to 11 percent during this same period. Moreover, the capital structures of the comparable companies differed significantly from the capital structures of CCC, Stahl, and Kaneland.

We are similarly unpersuaded by the comparable companies which Grabowski relied upon to value Holland. At the time of the transfers, a substantial portion of Holland's business consisted of the manufacture, assembly, and sale of rail welding equipment. Holland also provided welding services on a contract basis. The comparable companies which Grabowski relied upon were publicly traded companies engaged in the sale of various types of railroad equipment. These businesses were in no way similar to the rail welding business engaged in by Holland. Moreover, in his report, Grabowski stated that these companies were also engaged in numerous other businesses in addition to the railroad supply business. The record, however, does not disclose the nature of these businesses. Consequently, we conclude that Grabowski's comparable companies were not essentially engaged in the same or similar line of business as Holland. We therefore reject his market comparable valuation of Holland. We do not, of course, question that Grabowski used the best "comparables" he could find. We simply find that the market comparable approach is not available in this case in the absence of more reliable yardsticks.

We are similarly unable to accept Lerner's use of a modified market comparable approach to value CCC and its subsidiaries. Because he was unable to locate publicly traded companies engaged in the same or similar lines of business as CCC and its subsidiaries, Lerner relied on publicly traded companies with financial statistics similar to those of CCC. In choosing these comparable companies, Lerner did not look at the particular businesses in which they were engaged. Rather, he believed that investors would similarly value companies with comparable sales, returns on equity, and debt to equity ratios, regardless of the type of business in which they were engaged. We, however, are unable to agree with this theory.

It seems self-evident that every industry is characterized by its own peculiar risks and expectations. As a result, financial statistics which may be considered outstanding for one industry may be considered disastrous for another. For example, a large debt to equity ratio might be very acceptable to a willing buyer of stock in a company engaged in a business characterized by stable earnings while a similar debt to equity ratio might be unacceptable to that investor if the company were engaged in a business subject to volatile earnings. For the same reason, an investor cannot determine what constitutes a reasonable return on equity or adequate sales volume without considering the particular business of the company. We also point out that a company's total sales volume provides little evidence of the attractiveness of an investment in the absence of evidence of the company's overall profitability. Consequently, we do not believe that Lerner's modified market comparable approach provides an adequate indication of the intrinsic value of CCC and its subsidiaries.

On the record before us, we think that Grabowski's discounted cash-flow analysis provides a reasonable estimate of the intrinsic value of CCC, Stahl, Kaneland, and Holland. In Rev. Rul. 59-60, 1959-1 C.B. 237 (which is applied by both Grabowski and Lerner), it is stated that earnings are the most important factor to be considered in valuing stocks of manufacturing or service corporations. In this revenue ruling and the above-quoted estate and gift tax regulations, the following factors are listed as also relevant in determining stock values: (1) The economic outlook in general and the condition and outlook of the specific industry in general; (2) the financial condition of the business; and (3) its dividend-paying capacity. Because Grabowski's discounted cash-flow analysis takes into account all of these factors, we think that such analysis provides an appropriate method to use in valuing the common stock of CCC.

Grabowski's discounted cash-flow analysis is based upon he theory that the price which an investor will pay for a hare of stock is equal to the present value of the future tream of income which he expects to receive from the nvestment. Thus, as applied here, this valuation method elies primarily on the earnings of CCC and its subsidiaries, vhich, as Rev. Rul. 59-60 itself provides, is the most mportant factor to consider in valuing manufacturing and ervice companies like CCC, Stahl, Kaneland, and Holland. Moreover, in projecting the future income stream of these ompanies, Grabowski considered general economic condiions as well as the condition of the construction industry nd railroad supply industry, the companies' financial onditions and their dividend-paying capacity. Consequently, because Grabowski's discounted cash-flow analysis mphasizes the companies' past and future earnings as well s other relevant factors listed in respondent's regulations nd revenue rulings, we think that this valuation method is n appropriate method to use in determining the intrinsic alue of CCC, Stahl, Kaneland, and Holland.[22]

Respondent, nevertheless, attacks Grabowski's discounted ash-flow analysis on the ground that the projections of perating income are based on pure speculation. We demur. Rev. Rul. 59-60 states that:

> otential future income is a major factor in many valuations of losely-held stocks, and all information concerning past income which will e helpful in predicting the future should be secured. Prior earnings ecords usually are the most reliable guide as to the future expectancy, ut resort to arbitrary five-or-ten-year averages without regard to current ends or future prospects will not produce a realistic valuation. If, for stance, a record of progressively increasing or decreasing net income is ound, then greater weight may be accorded the most recent years' rofits in estimating earning power. It will be helpful, in judging risk and he extent to which a business is a marginal operator, to consider

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[22] In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court ecognized the validity of the discounted cash-flow method in reversing a lower court's ecision not to use the discounted cash-flow method in appraisal and other stock valuation roceedings. The court stated:

> he standard 'Delaware block' or weighted average method of valuation, formerly employed appraisal and other stock valuation cases, shall no longer exclusively control such roceedings. We believe that a more liberal approach must include proof of value by any chniques or methods which are generally considered acceptable in the financial community d otherwise admissible in court * * *" [457 A.2d at 712-713.]

> deductions from income and net income in terms of percentage of sales. * * * [1959-1 C.B. 237, 241.]

Thus, Rev. Rul. 59-60, itself, provides that potential future income is a major factor to consider in valuing the stock of a closely held corporation even though this factor cannot be established with certainty, but rather must be projected on the basis of prior earnings records. In the instant case, Grabowski made reasonable estimates of the future income of CCC, Stahl, Kaneland, and Holland based on their prior earnings. He also projected future expenses as a percentage of sales based on the companies' prior operating experience. Consequently, because projected future income is an essential factor to consider in valuing stock and because Grabowski's method of projecting future income satisfies the guidelines set forth in Rev. Rul. 59-60, we think that Grabowski's use of the discounted cash-flow method was appropriate in the instant case.

Respondent also attacks Grabowski's use of the Capital Asset Pricing Method (CAPM) to determine the cost of capital for CCC, Stahl, Kaneland, and Holland, maintaining that this formula is based on speculation and conjecture. We are, however, satisfied that the CAPM provides an acceptable formula to use in calculating the cost of capital for CCC and its subsidiaries.

The CAPM used by Grabowski is not based on unfounded speculation and conjecture, but rather requires the application of the appraiser's commonsense and informed judgment in weighing all the facts and circumstances in determining the cost of capital for a particular company. This approach to valuation is consistent with the statement in Rev. Rul. 59-60 that "A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance." Indeed, we have repeatedly recognized that stock valuation is not an exact science, but rather is "inherently imprecise and capable of resolution only by a Solomon-like pronouncement." *Messing v. Commissioner*, 48 T.C. 502, 512 (1967). We also note that respondent's expert, Lerner, described the CAPM as a "formal statistical measure of risk" whose use has flowered since 1951. Although Lerner further stated that the CAPM is presently on the wane because of the instability of the so-called "beta coefficient" (see below), he nevertheless also stated that numerous companies presently use the CAPM to estimate their cost of capital when making investment decisions.

Respondent also criticizes the CAPM on the ground that the appraiser's risk added by Grabowski is simply a different estimate of the same risk quantified by the beta coefficient. We disagree.

The beta coefficient is a ratio which compares the movement of stock prices for publicly traded companies deemed comparable to the company in issue with the movement of stock prices in general. In the instant case, had CCC been a large, publicly traded company, the beta coefficients relied on by Grabowski would have accurately reflected the company's perceived risk. However, because CCC is an unlisted, closely held corporation, an additional premium is needed to reflect the fact that investors view such corporations as being more risky than large, publicly traded companies. Thus, Grabowski's appraiser's risk reflects the additional risk inherent in CCC, Stahl, Kaneland, and Holland because they are unlisted closely held corporations.

In conclusion, after consideration of the entire record before us, we are satisfied that Grabowski's discounted cash-flow analysis accurately reflects the fair market value of the common equity of CCC, Stahl, Kaneland, and Holland before applying discounts for lack of control and lack of marketability. Consequently, based on Grabowski's discounted cash-flow analysis, we find that the total common equity of CCC had a value of $4,490,000 on the applicable valuation dates.

As to the remaining subsidiaries, Grabowski valued Suburban's real estate holdings and other assets, together with the investment real estate owned by CCC and Curran Development, at $2,665,000, which represented the liquidation value of those assets. Lerner, on the other hand, valued Suburban at $1,625,095, which represented the book value of its assets. Lerner did not individually value the investment real estate owned by CCC and Curran Development.

Although a company's liquidation value on occasion has been found to be an appropriate indication of that company's value (see *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978)), on the record before us we find it more appropriate to rely on Lerner's valuation of Suburban based on the book value of its assets. At trial, Grabowski stated that a substantial portion of his liquidation value determination was based on the assessed value of Suburban's real estate holdings as adjusted to reflect fair market value. Grabowski explained that he relied on the opinion of several local real estate appraisers to properly adjust the properties' assessed values to reflect their fair market value. Grabowski admitted, however, that the appraisers never viewed the property prior to determining the appropriate adjustments. Indeed, the record contains no evidence explaining the basis of these adjustments. Section 20.2031-1(b), Estate Tax Regs., states that "Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date."

We have recently held that assessed value may be considered when the relationship between assessed value and fair market value is demonstrated, but basically as a corroboration of fair market value determined by a more reliable method. *Estate of Kaplin v. Commissioner*, T.C. Memo. 1986-167. We apply this rule here. Since Grabowski has not shown the relationship between assessed value and fair market value, we think assessed values must be disregarded. We consequently rely on Suburban's book value of $1,625,095 as the fair market value of its stock.

Respondent, however, failed to provide any estimate of the fair market value of the real estate held by CCC and Curran Development. In the absence of other evidence indicative of the properties' value, we accept these properties' liquidation values as determined by Grabowski. Consequently, we find that the investment real estate owned by CCC and Curran Development had a fair market value of $415,000 on the applicable valuation dates.

For the reasons stated above, we conclude that the total fair market value of the common stock of CCC and its subsidiaries, before applying discounts for minority blocks and lack of marketability, was $6,530,095 on the applicable valuation dates. Our calculations may be summarized as follows:

Curran, Stahl, Kaneland, and Holland	$4,490,000
Suburban	1,625,095
Investment real estate	415,000
Total	6,530,095

We must next allocate $6,530,095 between CCC's class A voting common stock and class B nonvoting common stock. Petitioners and respondent agree that because the blocks of class A voting common represent minority positions, the class A voting shares are not more valuable than the class B nonvoting shares. Both parties therefore agree upon a pro rata allocation between the two classes of common stock. Consequently, we find that each share of CCC's class A voting common stock and class B nonvoting common stock had a value of $707.95 before applying a minority position discount and discount for lack of marketability.[23]

We now reach the point upon which the parties most strongly disagree. We must determine the appropriate discounts to apply for lack of control and lack of marketability. Petitioners contend that each 25-percent block of CCC's class A and class B common stock should be discounted 35 percent for lack of control. Petitioners rely on a study conducted by one Douglas Austin to support this figure. (The Austin study is not part of the record and we have not been asked to take judicial notice of its existence or contents.) Petitioners also maintain that the value of the class A and class B shares should be further reduced by discounts of 20 percent and 90 percent, respectively, for lack of marketability. They contend that a willing buyer of one 25-percent block of class A stock would discount the stock by 20 percent because the remaining 75 percent of the class A stock will be held by irrevocable voting trusts with an actuarially determined duration of 97 years. Petitioners also contend that a willing buyer would discount the class A stock because of CCC's failure to pay dividends in the past. Petitioners further maintain that the difference in size between each 25-percent block of class A stock (6 shares) and each 25-percent block of class B stock (2,300 shares) supports their contention that the class B shares should be discounted 90 percent.

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[23] We determined this value as follows: total common equity of $6,530,095 divided by 9,224, the number of outstanding shares.

Respondent disagrees, maintaining that because CCC was a financially strong old-line company with excellent and aggressive management and the capacity to pay dividends, both classes of stock should be discounted by no more than 15 percent for lack of control and 20 percent for lack of marketability. Respondent contends that the restrictions on transferability placed on 75 percent of the outstanding shares of the class A and class B stock by the terms of the trusts should not be considered in determining the value of each 25-percent block of stock in issue. Respondent further argues that no additional discount should be applied to the class B shares based on the difference in size between each 25-percent block of the class A shares and the class B shares. After a careful review of the record, we think that a minority position discount of 25 percent and a discount of 20 percent for lack of marketability are appropriate for both classes of stock.

First, we point out that we can give little weight to Grabowski's reliance on the so-called Austin study, which is said to find that investors on average pay a premium of 35 percent in cash tender offers for stock representing a controlling interest in a company, to support a minority position discount of 35 percent in the instant case. The valuation of a closely held corporation, including the appropriate discount to apply to stock representing a minority position, must take into account all of the relevant facts and circumstances of the particular corporation under scrutiny. Grabowski, by relying on a study based on a sample of various corporations, has failed to consider the particular facts and circumstances a willing buyer would consider when discounting a block of stock representing a minority position in CCC.

We are similarly not convinced by respondent's assertion that a minority position discount of 15 percent is appropriate in this case. We do not think that this discount factor adequately reflects the amount a willing buyer would reduce the value of each 25-percent block of common stock for lack of control. Rather, based on all of the facts and circumstances contained in the record before us, we believe that a minority position discount of 25 percent would be appropriate in the instant case. In so holding, we have considered the fact that a purchaser of a 25-percent interest in CCC would not have sufficient voting power to elect members to CCC's board of directors and therefore would not be able to participate in the management of the company.[24] We have also considered, however, that under Delaware law, corporate officers and directors owe their corporation and its minority shareholders a fiduciary obligation of honesty, loyalty, good faith, and fairness. *Singer v. Magnavox Co.*, 380 A.2d 969, 977 (Del. 1977). Moreover, we point out that a willing buyer would be aware of the history of success experienced by CCC's past and present management and the dividend paying capacity of the company. Thus, although we believe that a potential investor would apply some discount to a 25-percent stock interest in CCC for lack of control, we do not think that his minority position would unduly deter a prospective investor from buying the 25-percent block of stock, given an appropriate discount in his purchase price.

Petitioners also contend that each 25-percent block of CCC's outstanding class B common stock must be discounted 90 percent for lack of marketability. They argue that a willing buyer of a 25-percent interest in the class B stock would discount that stock by 90 percent given the fact that the remaining 75 percent of the shares would be held in irrevocable trusts with an actuarially determined life of 97 years.

We agree with respondent that Grabowski's 90-percent discount figure is based upon a misconception of the law. In his testimony Grabowski stated:

> Well, for example, valuing the Jack Curran block of stock I would be presented with the—I was presented with the necessity of placing myself as a hypothetical investor as of May 7, 1976, presented with the opportunity to buy this stock. Looking at the form I see a very good historically sound financially stable firm. I also see though that we have a situation of 18 other shares of Class A common stock being held by three other trusts, the trustees of which are Curran Management. I also see 2,300 shares of Class B common stock held in another similar trust, two different trusts, Cecilia Simon's 76-2 trust, and for example, placing myself looking at the Jack Curran block of stock, Bill Simon's 76-2 trust.

> So I could—I would analyze what are the types of returns that I might anticipate at that point buying a block of six shares of common stock that provides some—the opportunity to vote, and 2,300 shares of Class B common stock not providing the opportunity to vote. Given this circumstance that the other shares are housed in these trusts, given that, I would have to look at well, what are the likely scenarios, or what are the likely returns I might receive from making this investment.

Grabowski was viewing each block of stock as a separate gift on the one hand and hypothetically valuing each block before the gift. On the other hand, he was assuming that the other gifts were a fait accompli. Grabowski perceived the trusts as a restriction on the stock when in fact the trusts were not in existence until the making of the gifts. The trusts were, of course, created simultaneously and in concert by the stockholders pursuant to the estate freeze plan. Respondent's expert, Lerner, with whom we agree on this point, considered the trusts irrelevant for valuation purposes because he looked at the value of the stock from the point of view of what the donor had given.

Section 2511(a) states that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Section 25.2511-1(a), Gift Tax Regs., explains further that the gift tax is an excise tax on the transfer, and is not a tax on the subject of the gift. Section 25.2511-2(a), Gift Tax Regs. (entitled "Cessation of donor's dominion and control"), provides:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, *is measured by the value of the property passing from the donor*, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable. [Emphasis supplied.]

With respect to the critical date for valuation purposes, section 2512 states that if the gift is made in property, the value thereof as the date of the gift shall be considered the amount of the gift. Section 25.2512-2(a) of the regulations addresses the method for determining the value of stocks and bonds. It states that the value of the stocks and bonds is the fair market value per share on the date of the gift.

Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981), addressed this issue in the estate tax context. The court was faced with the question of the valuation of stock includable in the decedent's gross estate at his death. The taxpayer had argued that shares of stock should be partitioned into two blocks prior to valuation, that the 99 shares which went to a charitable foundation should be valued separately from the 1 share which had a private destination. The taxpayer argued that because the estate tax is a tax on the transfer of property, the valuation of the property in the gross estate must take into account any changes in value brought about by the fact of the distribution itself. The court acknowledged that valuation may take into account changes brought about by the death of the testator. Usually death itself does not alter the value of property owned by the decedent, although in exceptional cases, such as when a small business loses the services of a valuable partner, death does change the value of property. See *United States v. Land*, 303 F.2d 170 (5th Cir. 1962). The court in *Ahmanson* stated:

> We must distinguish, however, the effect of "predistribution" transformations and changes in value brought about by the testator's death, from changes in value resulting from the fact that under the decedent's estate plan the assets in the gross estate ultimately come to rest in the hands of different beneficiaries. The estate tax is a tax upon a transfer as the Foundation contends. However, *it is a tax on the privilege of passing on property, not a tax on the privilege of receiving property*. * * * [*Ahmanson Foundation v. United States*, *supra* at 768. Emphasis supplied.]

In *Ahmanson*, the court concluded that a hypothetical bifurcation of stock would be contrary to the policy underlying the Federal estate tax. This is because it would be easy to implement a tax avoidance scheme whenever an asset in the gross estate would have a diminished value if divided among two or more beneficiaries.

Citing *Ahmanson* with approval, the Seventh Circuit Court of Appeals, in *Estate of Curry v. United States*, dealt with the post-transfer bifurcation theory in the following language:

> to permit the hypothetical bifurcation of an otherwise integrated bundle of property for valuation purposes would severely undermine the estate

> tax system and permit abusive manipulation by inviting an executor to invent elaborate scenarios of disaggregated disposition in order to minimize total value. For example, an estate in possession of all shares of a corporation, voting and non-voting, could, under the regime urged by the estate here, arbitrarily slice the voting share block so thinly as to deny attribution of a control premium to any resulting block. * * * [*Estate of Curry v. United States*, 706 F.2d 1424, 1428 (7th Cir. 1983).]

See also *Estate of Pudim v. Commissioner*, T.C. Memo. 1982-606, affd. without published opinion 742 F.2d 1433 (2d Cir. 1983).

We think the anti-bifurcation rationale explained in the estate tax context by the Seventh Circuit in *Estate of Curry* and by the Ninth Circuit in *Ahmanson Foundation* applies equally here in the gift tax context. The estate tax and the gift tax, both being excise taxes on transfers, are to be construed in pari materia. *Sanford's Estate v. Commissioner*, 308 U.S. 39, 44 (1939); *Carson v. Commissioner*, 71 T.C. 252 (1978), affd. 641 F.2d 864 (10th Cir. 1981). This case presents a paradigmatic example of the appropriateness of that rule of construction.

Given petitioners' concerted estate freeze plan put in place by the simultaneous gifts in trust, we find their attempt to discredit respondent's reliance on *Estate of Curry* and *Ahmanson Foundation* to be, with all due respect, disingenuous. Petitioners attempt to draw a distinction based upon the fact that the two cited cases involved the stock of a single majority stockholder, whereas here none were in control. In the context of this case, this is a distinction without a difference, because even petitioners cannot deny that in creating the estate freeze plan they marched in lockstep. So marching, their position was no different than that of a single majority stockholder.

After a careful review of all relevant facts and circumstances, we also find a discount of 20 percent for lack of marketability for both classes of common stock to be appropriate. In determining this discount factor, we recognize that the stock of unlisted, closely held corporations is generally difficult to sell. We also recognize that CCC had a history of paying little if any dividends. We believe, however, that these negative factors are substantially offset by the following positive factors: (l) The Curran companies had a stable or upward trend in earnings during the 5-year period 1971 through 1975, which trend was expected to continue in the future; (2) CCC was financially strong with excellent and aggressive management; and (3) CCC had a substantial dividend-paying capacity.

In conclusion, after applying a minority position discount of 25 percent and a discount of 20 percent for lack of marketability, we find that each share of CCC's class A voting common stock and class B nonvoting common stock had a value of $389.37.

To reflect the foregoing,

Decisions will be entered under Rule 155.

THE STANLEY WORKS AND SUBSIDIARIES, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26475-83. Filed August 12, 1986.

In 1977, petitioner donated to a charitable donee a conservation easement in land adjacent to the Housatonic River in northwestern Connecticut. Petitioner deducted a charitable contribution with respect to the donation based on a value for the easement of $12 million. *Held*, the highest and best use of the land before the donation of the easement was for the construction of a hydroelectric power plant. *Held, further*, the value of the easement was $4,970,000. *Held, further*, petitioner is liable for the increased interest rate on substantial underpayments attributable to tax motivated transactions under sec. 6621(d), I.R.C. 1954.

Walter B. Slocombe and *Geoffrey J. Vitt*, for the petitioner.

Kendall C. Jones, for the respondent.

SWIFT, *Judge*: In a statutory notice of deficiency dated June 17, 1983, respondent determined deficiencies in petitioner's Federal corporate income tax liabilities as follows:

TYE—	*Deficiencies*
Jan. 1, 1978	$773,642
Dec. 31, 1978	1,138,709

The primary issue remaining for decision is the amount petitioner is entitled to deduct with respect to a charitable contribution of a conservation easement in 668 acres of land located adjacent to the Housatonic River in northwestern Connecticut. Also at issue is whether petitioner, under section 6621(d),[1] is liable for the increased rate of interest imposed on substantial underpayments of tax attributable to tax motivated transactions.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The Stanley Works (hereinafter referred to as petitioner), is a Connecticut corporation with its principal place of business in New Britain, Connecticut. Petitioner and its wholly owned subsidiaries timely filed Federal consolidated corporate income tax returns for their taxable years ending January 1, 1978, and December 31, 1978.

Petitioner is a multimillion dollar corporation that principally is engaged in the manufacture and sale of hand tools and hardware. Between 1906 and 1916, petitioner acquired approximately 2,200 acres of unimproved land located on both sides of the Housatonic River in Litchfield County, Connecticut (hereinafter referred to as the Stanley Works property). Petitioner acquired the entire Stanley Works property for $48,582 and originally intended to dam the Housatonic River and to construct a hydroelectric power plant on the property. Petitioner intended to use the electricity generated at the proposed plant in one of its nearby manufacturing plants and to sell any excess electricity to local public utility companies.

Between 1918 and 1924, however, petitioner purchased a small Connecticut utility company, rebuilt the hydroelectric power plant owned by that company, and began generating electricity therefrom in 1924 for use in petitioner's Connecticut manufacturing plants. As a result thereof, petitioner did not pursue construction of a power plant on the Stanley Works property, and petitioner has not made any commercial or industrial use of the Stanley Works property since the time it was purchased. All 2,200 acres of the Stanley Works property constitute essentially a wilderness area with only a few old barns located thereon.

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[1] All section references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

Two hydroelectric power plants were constructed on the Housatonic River in the 1920's. One was located on the river above and one was located below the Stanley Works property. In the early 1960's, the Connecticut Light & Power Co. offered to purchase the Stanley Works property for $500,000. It intended to construct thereon a hydroelectric power plant. Petitioner rejected the offer, but as a result of receiving the offer, petitioner in 1961 conducted a study of the feasibility at that time of constructing a hydroelectric power plant on the property. Petitioner's 1961 study concluded that construction of a conventional hydroelectric power plant on the Stanley Works property would not be economical, but that the property would be suitable for the construction thereon of a particular type of hydroelectric power plant known as a pumped storage plant.

A pumped storage plant provides supplemental electrical power during periods of peak energy demand in the following manner. During evenings or weekends when electrical power demand is low, water is pumped from a lower reservoir—such as a river or lake—up to a storage reservoir at a significantly higher elevation than the lower reservoir. When supplemental electrical power is needed during periods of peak energy demand, water is released from the upper reservoir. As water flows back down to the lower reservoir it passes through tunnels wherein it turns hydraulic turbine generators, thereby producing electrical power. The electrical power produced as the water flows through the turbines obviates the need during peak-demand periods to purchase or to produce a similar amount of electrical power by other, more expensive methods. The size of the upper and lower water reservoirs and the difference in their elevations determine the amount of electrical power that can be produced by a pumped storage plant.

The construction of pumped storage plants requires a particular site or land topography because the location of the upper reservoir must be at a sufficiently high elevation in relation to the lower reservoir, but not be too distant laterally from the lower reservoir, to permit efficient operation. Pumped storage plants also must be built adjacent to large natural sources of water that readily can supply the water that is pumped to the upper reservoirs.

A decision of a utility company to construct a pumped storage plant is based, in part, on forecasts of future demand for peak-period electrical power. In planning to meet that demand, a utility company also must consider the 10- to 15-year "lead time" it takes to license and construct a power plant. Utility companies in a particular region form "power pools" to forecast future energy demand and to coordinate and plan future construction of electrical power plants. Power pools do not have authority to direct member utility companies to construct new plants. The construction of new power plants by utility companies, however, is significantly influenced by the future energy requirements forecasted by the power pools.

In the northeastern United States, approximately 250 utility companies are members of the New England Power Pool (NEPOOL), and in New York approximately 10 utility companies are members of the New York Power Pool (NYPP). During the 1960's and early 1970's, the forecasts by NEPOOL and NYPP of the long-term demand for peak-period electrical power was an increase of 8 percent per year. Pumped storage plants were highly regarded by the utility industry and by Federal regulatory agencies as a viable means of meeting that expected increase in demand for sources of power during peak-demand periods.

In 1977, when petitioner donated the easement at issue herein, NEPOOL had forecasted a 5.4-percent annual increase in peak-demand electrical power and a need for 5,500 megawatts of additional electrical generating capacity to be produced from seven or more new pumped storage plants in New England. The first was projected to be finished and operational by 1992. Also in 1977, NYPP had forecasted the need for 2,500 megawatts of additional electrical generating capacity to be produced from pumped storage plants within its region.

Neither NEPOOL ,nor NYPP in 1977 had recommended specific sites for the new pumped storage plants that were forecasted over the subsequent 15 years and it was reasonable to assume that the Stanley Works property could have been selected as such a site.

The Stanley Works property was suitable for a mid-sized (800 megawatt) pumped storage plant due primarily to the

950-foot rise in elevation from the floor of the Housatonic River—where the river would be dammed to provide a lower reservoir—to the area where the upper reservoir most likely would be constructed (referred to as Pine Swamp). Pine Swamp was not located within the 2,200-acre Stanley Works property and, therefore, any developer of a pumped storage plant who intended to use the Stanley Works property as the site of a lower reservoir would have been required to purchase Pine Swamp or other nearby land as the site for the upper reservoir.

During the 1960's, interest increased in constructing a pumped storage plant on the Stanley Works property. In 1963, Connecticut Light & Power Co. considered 27 potential pumped storage sites in Connecticut and western Massachusetts. Of the 27 sites considered, 24 sites were eliminated upon initial inspection. The Stanley Works property was one of the remaining three sites that were considered in detail and it was recommended as the superior site of the three sites under final consideration on which a mid-sized pumped storage plant might be constructed. The 1963 study estimated the cost of acquiring the Stanley Works property at that time at $1,500,000.

In 1966, Connecticut Light & Power Co. merged with Northeast Utilities, the largest public utility company in the NEPOOL region. Sometime thereafter, Northeast Utilities purchased the Pine Swamp property and identified the Stanley Works property on its internal planning maps as the possible site for construction of a pumped storage plant.

In 1967, Northeast Utilities considered four potential pumped storage sites, including the Stanley Works property, and concluded that of the four sites considered at that time, the Stanley Works property was the least suitable site, primarily due to the limited size and generating capacity of any pumped storage plant that could be built thereon. As a result of the conclusions it reached in 1967, in early 1970, Northeast Utilities applied to the Federal Power Commission (FPC)[2] for study permits (a preliminary step before applying for a Federal license) to conduct further indepth, on-site examinations of two of the four sites it had considered in 1967. The two sites selected for further consideration were at Canaan Mountain, Connecticut, and at Sheffield, Massachusetts. Those sites both were suitable for large (2,000 megawatt) capacity pumped storage plants and were located 20 to 30 miles north of the Stanley Works property on tributaries of the Housatonic River.

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[2] The FPC is the Federal agency responsible for licensing the construction of all power plants in the United States and is now known as the Federal Energy Regulatory Commission, or FERC.

During the late 1960's and early 1970's, public utility companies throughout the United States (particularly Northeast Utilities) became more sensitive to the increasing public concern for environmental planning in the construction of power plants. In 1969, Peter Stern (Stern), the vice president for environmental planning at Northeast Utilities, personally inspected the Stanley Works property and advised the company's board of directors that any proposal it might entertain to construct a pumped storage plant on that property would encounter major environmental opposition.[3] Upon Stern's recommendation, Northeast Utilities did not further investigate the construction of a pumped storage plant on the Stanley Works property. In 1971, Northeast Utilities also withdrew from the FPC its applications for study permits with respect to the Canaan Mountain and Sheffield sites.

In July of 1973, the New England River Basin Commission (NERBC), a Federal commission established to coordinate the planning efforts of public utility companies in New England, issued a report concerning 52 potential pumped storage sites in the northeastern United States. The report identified the Stanley Works property as such a potential site. It concluded, however, that the construction of a pumped storage plant on the Stanley Works property would cause "obvious and unacceptable environmental disruptions" due to "unique river characteristics [of the] lower pool." The NERBC report provided no further elaboration of its conclusion regarding the Stanley Works property, but its conclusion in regard thereto was based on the erroneous assumption that a 2,100-megawatt pumped storage plant would be constructed on the Stanley Works property, rather than an 800-megawatt plant as previously had been anticipated by Northeast Utilities. A 2,100-megawatt pumped storage plant would require a significantly larger lower reservoir, inundate a significantly larger area of land, and result in significantly greater environmental impact to the Stanley Works and surrounding properties than would an 800-megawatt pumped storage plant.

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[3] Stern noted a number of factors that prompted his recommendation, including: (1) The construction of a pumped storage plant on the Stanley Works property would have eliminated the free-flowing state of the Housatonic River; (2) the configuration of the site would have caused an approximate 20-foot fluctuation in the lower reservoir thereby seriously impairing the aesthetic quality and recreational use of the property; and (3) the lower reservoir would have had an impact on Kent Falls State Park and would have impaired the scenic quality of waterfalls located in the park.

By letter to Northeast Utilities dated November 9, 1973, petitioner inquired as to that company's intention with respect to the Stanley Works property. After a "comprehensive review," Northeast Utilities responded by letter dated January 24, 1974, "that it would not now * * * purchase the property."

On October 12, 1976, 41 miles of the Housatonic River, including the 7 miles of the river that flow through the Stanley Works property, became the subject of a study pursuant to the Federal Wild and Scenic Rivers Act, 16 U.S.C. sec. 1271 et seq. (1982). The Wild and Scenic Rivers Act was passed by Congress in 1968 (82 Stat. 906 (1968)), to protect and preserve in free-flowing condition rivers that possessed outstanding scenic or recreational characteristics. At the instigation of either Congress or a State legislature, rivers were to be selected pursuant to that act for study by the Secretary of the Interior. If, after study, the Secretary recommended to Congress that a particular river should be designated for Federal protection, Congress had a 3-year period in which to vote on the recommendation. One important consequence of designation for study as a scenic river under that Federal statute was that the FPC was prohibited from licensing the construction of any hydroelectric power plant on the river during the 3-year period the river was under study by the Secretary of the Interior and during the additional 3-year period legislation was being considered with respect to a particular river.

If Congress voted to include a particular river in the Federal river system, the FPC thereafter was prohibited from licensing the construction of any hydroelectric power plant on the river. The act does not provide for compensation to riparian landowners. Therefore, as of October 12, 1976, because of its designation for study as a river with outstanding scenic and recreational characteristics, there existed a federally imposed 3-year moratorium on the construction and licensing of all power plants on the Housatonic River. It was during this moratorium period that petitioner donated the easement at issue herein.

On October 2, 1979, the study conducted by the Secretary of Interior recommended that the Housatonic River not be included in the Federal river system and that environmental protection of the Housatonic River was better left to State and local officials. That recommendation apparently was prompted by the objection of most owners of land adjacent to the Housatonic River to federally imposed environmental controls. The Housatonic River thus remained under State control and the moratorium applicable to development of the Housatonic River expired in 1982.[4]

Prior to its donation of the easement in question, petitioner had made donations of other interests in the Stanley Works property for purposes of historical or environmental conservation. In 1968 and 1976, petitioner donated a fee interest in 27 acres of the Stanley Works property to the State of Connecticut for a museum.

Also in 1976, petitioner donated a fee interest in 132 acres of the Stanley Works property to an environmental conservation organization. That property consisted of a portion of the St. John's Ledges, a particularly scenic stretch of cliffs along the Housatonic River, and an additional 12 acres for a park. Petitioner also granted in 1976 to the same environmental conservation organization a 200-foot-wide easement through the Stanley Works property (approximately 50 acres) for use as part of the Appalachian Trail. The Appalachian Trail stretches from Maine to Georgia, and the 5-mile stretch that runs along the Housatonic River through the Stanley Works property is the longest river walk on the Appalachian Trail.

In making the above donations in 1968 and 1976, however, petitioner at all times preserved its right to dam the Housatonic River and flood the Stanley Works property to the 405-foot topographic contour level consistent with its original intention to construct a hydroelectric power plant thereon. Petitioner also expressly retained the right to relocate the portion of the Appalachian Trail on its property since construction of a lower reservoir on the Stanley Works property for a pumped storage plant would inundate the original portion of the Appalachian Trail on the property.

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[4] The Federal study of the Housatonic River commenced on Oct. 12, 1976, and ended Oct. 2, 1979. The additional 3-year moratorium on Federal licensing expired on Oct. 2, 1982.

On June 10, 1977, petitioner transferred to the Housatonic Valley Association (HVA) the easement at issue herein encompassing approximately 7 miles of river-front land. The easement was conveyed for a term of 30½ years. It barred all commercial development on 668 acres of the Stanley Works property and required preservation of the land in its natural, scenic, and open condition. The easement also barred the construction of any hydroelectric power plant for the 30½-year life of the easement on any portion of the entire Stanley Works property.[5]

The HVA is a qualified charitable donee as described in section 170(c), and was formed to preserve the scenic environment of the Housatonic River Valley. Under the terms of the easement, HVA was given the right to enforce the easement, to verify that the limits on development were complied with, and to permit limited research and recreational use of the property. The easement did not confer on HVA any valuable affirmative rights to develop the property. Petitioner continued to be obligated to pay real estate taxes with respect to the property.

On its Federal corporate income tax returns for its taxable years ending January 1, 1978, and December 31, 1978, petitioner valued the conservation easement donated to the HVA at $12 million. Because of the limitation on corporate charitable deductions then in effect under section 170(b)(2), petitioner deducted $2,236,253 with respect to the donation of the easement in its taxable year ended January 1, 1978. Pursuant to the carryover provisions of section 170(d)(2), petitioner deducted $2,372,311 with respect to its donation of the easement in its taxable year ended December 31, 1978.

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[5] The deed that conveyed the easement was signed by representatives of the HVA and petitioner just 4 days before the effective date of a new Federal tax provision that limited charitable deductions allowable under sec. 170(f)(3)(B)(iii) to easements that were granted in perpetuity to qualified charitable donees. The parties herein agree (and the Court does not intend to suggest otherwise) that the deed was a valid legal instrument and that petitioner is entitled to take advantage of sec. 170(f)(3)(B)(iii) as it was effective for contributions made prior to June 14, 1977. Cf. *Hagler v. Commissioner*, 86 T.C. 598 (1986).

In his notice of deficiency, respondent determined that the decrease in the value of the Stanley Works property as a result of the easement was $619,700, and respondent disallowed the charitable deductions claimed with respect to the donation to the extent they exceeded that amount. The parties now agree for the purposes of this case that the decrease in the value of the Stanley Works property as a result of the donation of the easement was at least $1,100,000. That amount ignores any value accruing to the property relating to its potential as the site for construction of a pumped storage plant.

At trial held in Washington, D.C., expert witnesses, among others, testified for petitioner and respondent as to the likelihood, at the time the easement was donated to HVA, that the Stanley Works property would have been developed as the site for a pumped storage plant. Testimony also was presented concerning the value of the property and the effect of the easement on the value of the property.

OPINION

Valuation of the Conservation Easement

Generally, under section 170(f)(3)[6] no deduction is allowed with respect to a charitable contribution of less than the taxpayer's entire interest in the property contributed. In 1976, however, Congress expressly provided an exception for, among other things, contributions of easements with respect to real property of not less than 30 years' duration that are donated to qualified charitable organizations exclusively for conservation purposes. Sec. 170(f)(3)(B)(iii) and (C). Conservation easements ordinarily do not confer on the owners thereof any affirmative rights for development of the property. They do, however, provide a general benefit to society by restricting the donor's full use of the property and thereby preserving in an undeveloped state uniquely scenic land, buildings, and natural resources.

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[6] Sec. 170(f)(3) as in effect for gifts made prior to June 14, 1977, provides in relevant part:

(3) DENIAL OF DEDUCTION IN CASE OF CERTAIN CONTRIBUTIONS OF PARTIAL INTERESTS IN PROPERTY.—

(A) IN GENERAL.—In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust. * * *

(B) EXCEPTIONS.—Subparagraph (A) shall not apply to a contribution of—

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(iii) a lease on, option to purchase, or easement with respect to real property of not less than 30 years' duration granted to an organization described in subsection (b)(1)(A) exclusively for conservation purposes * * *

(C) CONSERVATION PURPOSES DEFINED.—For purposes of subparagraph (B), the term "conservation purposes" means—

(i) the preservation of land areas for public outdoor recreation or education, or scenic enjoyment;

(ii) the preservation of historically important land areas or structures; or

(iii) the protection of natural environmental systems.

The gift of a conservation easement to a qualified charitable organization is not, per se, a tax gimmick. Congress fully intended to allow a deduction with respect to such contributions, and respondent concedes that petitioner meets all the requirements of section 170(f)(3)(B)(iii) and (C).

The amount allowed as a deduction with respect to a charitable contribution of property usually is determined by the fair market value of the property on the date of the gift. Sec. 1.170A-1(c)(2), Income Tax Regs.[7] If no comparable sales of easements are available to determine the value of the easement in question, the value of a conservation easement for tax purposes will be determined by the "before and after" valuation of the underlying property. Under that approach, the difference between the fair market value of the Stanley Works property immediately before the contribution of the easement is to be compared with the fair market value of the property immediately after the easement was contributed. See, e.g., *Hilborn v. Commissioner*, 85 T.C. 677, 688 (1985); *Akers v. Commissioner*, T.C. Memo. 1984-490, on appeal (6th Cir., Feb. 8, 1985); *Thayer v. Commissioner*, T.C. Memo. 1977-370. See also sec. 1.170A-14(h)(3)(ii), Income Tax Regs., applicable to gifts made after Dec. 18, 1980. The parties now agree that the contribution of the easement decreased the fair market value of the Stanley Works property by at least $1,100,000 and that no portion of that agreed-upon decrease is attributable to the potential to develop the property as the site for a pumped storage plant.

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[7] "Fair market value" is defined in sec. 1.170A-1(c)(2), Income Tax Regs., as—

"the * * * price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. * * *"

Petitioner contends that an additional $10,900,000 decrease in the value of the Stanley Works property occurred as a result of the conveyance of the easement and that that additional decrease in value is attributable to petitioner's inability (for 30-plus years thereafter) to construct a pumped storage plant on the property. Respondent contends that whatever potential previously may have existed for construction of a pumped storage plant on the Stanley Works property, such potential realistically no longer existed in 1977. Respondent, therefore, contends that other than the agreed upon $1,100,000 decrease in value, no decrease in the value of the Stanley Works property occurred in 1977 as a result of the contribution of the easement.

The fair market value of property reflects the highest and best use of the property on the relevant valuation date. Any realistically available special use of property due to its adaptability to a particular business is an element that must be considered in determining the fair market value thereof. *Mitchell v. United States*, 267 U.S. 341, 344-345 (1925); *Hilborn v. Commissioner, supra*. The fair market value of property is not affected by whether the owner actually has put the property to its highest and best use. The realistic, objective potential uses for property control the valuation thereof. *United States v. Meadow Brook Club*, 259 F.2d 41, 45 (2d Cir. 1958). One court commented on this principle of valuation many years ago as follows: The landowner "may have used a valuable corner [of property] for a stable or for a pigsty * * * [but] he is not obliged to have it priced on that basis." *Central Georgia Power Co. v. Stone*, 139 Ga. 416, 419, 77 S.E. 565, 567 (1913).

Several cases have addressed the application of the above principles of valuation to property suitable for a hydroelectric power plant. The special suitability of property as the site for a hydroelectric power plant is a factor to be considered in determining its fair market value. *Grand River Dam Authority v. Grand-Hydro*, 335 U.S. 359, 372-373 (1948); *Olson v. United States*, 292 U.S. 246, 257 (1933); *United States v. Cooper*, 277 F.2d 857, 861 (5th Cir.

1960); *Week v. Commissioner*, 26 B.T.A. 340 (1932), affd. 68 F.2d 693 (9th Cir.), cert. denied 292 U.S. 657 (1934). Physical suitability of property, however, for a hydroelectric power plant is not deemed sufficient in and of itself to affect the market value of the property. Before an additional element of value may be attributed to potential use of property for the construction of a hydroelectric power plant, the taxpayer must establish that there existed a reasonable probability the land would be so used in the reasonably near future. *Olson v. United States*, *supra* at 257.

In *Olson v. United States*, the United States instituted a condemnation proceeding to acquire water drainage easements over certain property in Minnesota adjacent to a lake which straddles the U.S.-Canadian border.[8] The property owner argued that his property, if joined with several adjacent properties, could have been used for construction of a power plant, and that the fair market value of damages to the property as a result of the easements the Government obtained should reflect that potential use of the property. The Supreme Court held that, in spite of the suitability of the property in question for construction of a power plant, there was no reasonable probability the property would be acquired for that purpose in the reasonably foreseeable future. The Court held, therefore, that no element of the property's value legitimately could be attributed to the suitability of the property for construction of a power plant. The Supreme Court stated in *Olson*—

> Elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable, should be excluded from consideration, for that would be to allow mere speculation and conjecture to become a guide for the ascertainment of value—a thing to be condemned in business transactions as well as in judicial ascertainment of truth. * * * [292 U.S. at 257.]

The focus of the above-quoted language, as applied to this case, is whether it is reasonable to conclude that a hypothetical willing buyer in 1977 would have considered the Stanley Works property as the site for construction of a pumped storage plant. If a hypothetical buyer would not reasonably have taken into account that potential use in agreeing to purchase the property, such potential use should not be considered in valuing the property. *United States v. 320.0 Acres of Land*, 605 F.2d 762, 781 (5th Cir. 1979).

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[8] The principles and legal precedents governing the determination of fair market value of property in tax cases are the same as those that control the valuation of property in condemnation cases. *Great Northern Railway Co. v. Weeks*, 297 U.S. 135, 139 (1936); *Klopp v. Commissioner*, T.C. Memo. 1960-185.

In considering whether there is a reasonable probability that property will be used as the site for construction of a hydroelectric power plant, it is important to know whether additional land would have to be purchased to construct the power plant. If so, it must be reasonably probable that the property owner would be able to acquire the additional land in the reasonably near future without relying on the power of eminent domain. *United States ex rel. Tennessee Valley Authority v. Powelson*, 319 U.S. 266, 276 (1942) (*Powelson*). In the absence of such a showing, the prospect for the use of property as the site for the construction of a power plant is regarded as too remote and speculative and will not be considered in the valuation of property. *Powelson, supra* at 276, citing *McGovern v. City of New York*, 229 U.S. 363, 372 (1913).

Legal restrictions on the use of property are relevant in determining whether an alleged use of property is reasonably probable. In *Great Northern Nekoosa Corp. v. United States*, 544 F. Supp. 511 (D. Me. 1982), affd. 711 F.2d 473 (1st Cir. 1983), a taxpayer donated to the State of Maine a perpetual easement with respect to 207 acres of land on the Allagash River in northern Maine. The taxpayer claimed a charitable contribution deduction with respect to the donation in the amount of $1 million. As the basis for its valuation of the easement, the taxpayer claimed that the highest and best use of the property before the donation was for the construction of a hydroelectric power plant. The claimed deduction was disallowed because at the time the donation was made, State laws had been enacted to preserve the natural scenic beauty of the Allagash River. The State laws absolutely prohibited the construction of any hydroelectric power plant on the Allagash River. In addition, in 1969 when the donation was made, the Allagash River was being considered for inclusion in the Federal river system, and the river actually was included in the system in 1970. The District Court found that legal obstacles to the development of a power plant on the taxpayer's land foreclosed any special use valuation thereof as the potential site for the construction of a hydroelectric power plant. 544 F. Supp. at 515. In affirming the decision of the District Court, the First Circuit held that, as of the date of the donation, designation of the Allagash River as part of the Federal scenic river system was so certain to occur that it necessarily would have significantly reduced the price any knowledgeable buyer would have paid for the property. 711 F.2d at 475. See also sec. 1.170A-14(h)(3)(ii), Income Tax Regs., applicable to donations made after Dec. 18, 1980.

Having reviewed the legal principles applicable to the valuation of charitable easements and the valuation of property where it is alleged that the property has a particular special use, we turn to the specific contentions of the parties herein. As explained, petitioner asserts that the value of the Stanley Works property was diminished by $10,900,000 as a result of the easement it donated to the HVA. The original Stanley Works property consisted of approximately 2,200 acres. Because of donations by petitioner of approximately 150 acres of the property to charitable donees before the donation of the easement in question, the parties herein agree that the total acreage remaining a part of the Stanley Works property at the time of the donation in question in 1977 was 2,100 acres. The parties also agree that although the easement primarily affected only 668 acres of the property, it affected the value of the entire 2,100 acres because, under the terms of the easement, petitioner was precluded from constructing a power plant on any portion of the property.

Petitioner argues that in 1977 the Stanley Works property was recognized by the utility industry as one of the few sites in the northeast region of the United States that was suitable for a pumped storage plant; that demand in the northeast region for peak electrical power was projected to increase; and that construction of additional pumped storage plants in the reasonably near future was anticipated. Petitioner admits that development of a pumped storage plant on the Stanley Works property would have had adverse environmental impact on the Housatonic River and the Appalachian Trail, but petitioner argues that such impact could have been mitigated and would not have been so great as to preclude construction of a power plant on the property.

Petitioner offered evidence from expert witnesses concerning the generation of electrical power by pumped storage plants, concerning environmental laws regulating such plants, and concerning the value of petitioner's property. Petitioner's expert on pumped storage plants testified that demand in the United States for electrical power experienced uninterrupted growth of about 8 percent per year between 1945 and 1973, and that during those years the number of power plants in the United States doubled approximately every 10 years.

During the Arab oil embargo in 1973 and 1974, electricity generated from fossil fuels became more costly, energy conservation efforts increased, and projected growth in peak-power demand in the NEPOOL region declined to 3.5 percent per year. By 1977, however, long-term growth in peak-power demand, as forecasted by NEPOOL, had rebounded to an average annual growth rate of 5.5 percent and construction of new power plants was expected to continue. Petitioner's expert opined that in 1977 the need for as many as 10 new pumped storage plants was projected in the NEPOOL and NYPP regions to meet the forecasted increase in demand for peak power.

Petitioner's expert on pumped storage plants also testified that the Stanley Works property was one of the most desirable sites in the NEPOOL and NYPP regions for such a plant. He noted that many utility companies throughout the northeast region could have utilized the electrical power generated from a pumped storage plant on that property through existing power transmission networks and interconnection agreements. The expert stated that although Pine Swamp would be the preferred site for the upper reservoir, a number of other sites also would be suitable for the upper reservoir.

Petitioner submitted evidence from an environmental law expert who concluded that construction of a pumped storage plant on the Stanley Works property would have had little impact on noise level and water quality, and generally would not have been prohibited by land use or aesthetic considerations. The expert did concede that a pumped storage plant would adversely affect wetlands and certain rare or endangered mammal and amphibian species living on the Pine Swamp property, but he opined that those consequences could be mitigated and would not have barred licensing of a power plant. The expert testified that in the past 50 years, the Federal Government has licensed hundreds of hydroelectric power plants, but in only one instance has a license been denied for environmental reasons, and that it would have been highly unlikely for the FPC in 1977 to have refused to license the construction of a small and relatively noncontroversial pumped storage plant on the Housatonic River.

Petitioner's environmental law expert testified further that there was only a slight chance the Housatonic River would be included in the Federal Wild and Scenic Rivers system. The expert opined that in June of 1977 it would have been obvious to anyone familiar with the Housatonic River that the local political support essential for inclusion of the river in the Federal river protection system was lacking.

Finally, petitioner's expert on valuation of the Stanley Works property used three methods to value the property before the easement in question was donated to the HVA. First, he analyzed 16 pumped storage plants operating in the United States in 1977 and found that the land acquisition cost of each plant was about 6 percent of total plant costs. The expert then estimated the 1977 cost of constructing an 800-megawatt pumped storage plant (exclusive of land) at $203 million and by applying the 6-percent cost factor for the land concluded that the cost of acquiring the Stanley Works property would have been approximately $13 million.

The second method used by petitioner's valuation expert to value the Stanley Works property before the easement was donated started with the 1963 study of the Stanley Works property by Connecticut Light & Power Co., which had placed an estimated purchase price on the property of $1,500,000. He increased that 1963 estimated cost to 1977 land prices using a land inflation factor of 3.6 percent, reflecting the general rise in the price of farm property in

Connecticut between 1963 and 1977. Under that method, petitioner's expert estimated the fair market value of the Stanley Works property in 1977 to be $5,394,000.

The third method used by petitioner's expert for valuing the Stanley Works property before the easement was donated was based on the average price paid per acre for land on which pumped storage plants were constructed in the northeast region of the United States, adjusted for inflation to 1977 prices using a 3.6-percent inflation factor. Under that method, the average per-acre value of such land was $3,327, which results in an estimated value for the Stanley Works property of $6,986,700. Petitioner's expert also contends that because the Stanley Works property was a large, already-assembled tract of land, it would command a 20-percent premium under this third method (or a total price of $8,384,040) from a hypothetical buyer because the buyer would be able to avoid the time and expenses of assembling smaller tracts of land from several sellers.

With regard to the value of the 2,100-acre Stanley Works property after the easement was donated, petitioner presented evidence that the price for which farmland in Connecticut was selling in 1977 was $800 per acre, or a total "after value" of $1,680,000.

Respondent contends that although in the early 1960's some interest had been expressed by local utility companies in the Stanley Works property as the site for construction of a pumped storage plant, by the early 1970's the site had been finally rejected for that purpose because of environmental concerns and because of the limited forecasts at that time for additional pumped storage plants in New England. Respondent emphasizes the public opposition in New England and in communities along the Housatonic River to other power plant projects in the early 1970's and the failure of petitioner or any utility company in the region to actually plan a specific project for the Stanley Works property. Respondent also contends that there is no competent evidence in the record to support the $12 million value for the easement as claimed by petitioner.

Respondent and petitioner agree that as a result of the contribution of the easement, the diminution in the value of the Stanley Works property without regard to its potential as a pumped storage plant was $1,100,000, but respondent has offered no alternative valuation of the property before the donation of the easement should we find that the value of the property is to be determined with reference to its potential use as a pumped storage plant.

An expert witness for respondent testified that delays in and cancellations of the construction of nuclear power plants (which provide most of the power for the region) had diminished the need for additional pumped storage plants in New England by 1977.[9] He relies on a NEPOOL projection in 1975 that no new pumped storage plants would be necessary in the region through the mid-1980's. Although he forecasted a demand, as of 1977, for an additional 2,000 megawatts of pumped storage capacity by the early 1990's, respondent's expert suggested that that additional capacity would have been supplied by Northeast Utilities' planned pumped storage plants at Canaan Mountain or Sheffield. Therefore, in the expert's opinion, in 1977, there would have been no interest in using the Stanley Works property as the site for a pumped storage plant.

Even if there were additional demand for pumped storage plants, respondent argues that environmental objections would have precluded licensing of the Stanley Works property for construction of a pumped storage plant. Respondent points to the 1973 NERBC study which rejected the Stanley Works property as a potential site for a pumped storage plant due to "obvious and unacceptable environmental disruptions," and to the rejection of the site for the same use by Northeast Utilities in 1974. Respondent's expert opined that destruction of a white-water canoe run, flooding of the Appalachian Trail, and interference with the view of the St. John's Ledges, all of which would result from construction of a dam on the Housatonic River (if a pumped storage plant was constructed on the Stanley Works property), were significant environmental factors that support his conclusion.

What has been said previously regarding the valuation of property particularly applies to the valuation problem presented to us in this case. The issue presents a fact question that can be resolved only by weighing all of the evidence. The issue presents a problem of judgment, not mathematics. *Hamm v. Commissioner*, 325 F.2d 934, 940 (8th Cir. 1963), affg. a Memorandum Opinion of this Court. "Valuation is * * * necessarily an approximation." *Silverman v. Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976), affg. a Memorandum Opinion of this Court. It is an inexact science at best, capable of resolution only by "Solomon-like" pronouncements. *Ketteman Trust v. Commissioner*, 86 T.C. 91, 98 (1986); *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 452 (1980); *Estate of Heckscher v. Commissioner*, 63 T.C. 485 (1975). The Second Circuit has stated that—

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[9] Because pumped storage plants supplement electrical power output of other electrical generating plants during peak periods, a reduction in the number of primary plants (such as nuclear power plants) reduces the need for pumped storage plants.

> finding market value is, after all, something for judgment, experience, and reason on the part of the trier, and does not lend itself to dissection and separate evaluation. [*Colonial Fabrics v. Commissioner*, 202 F.2d 105, 107 (2d Cir. 1953).]

We carefully have examined all of the testimony and documentary evidence introduced in this case. The testimony of each of the expert witnesses has been helpful. We are satisfied that, at the time the easement was conveyed to the HVA, there was a reasonable probability the Stanley Works property would be developed as a pumped storage plant in the reasonably near future. Therefore, the value of the property before the gift of the easement should reflect that potential special use. Our conclusion is based primarily on the following factors that existed at the time of the gift: (1) The anticipated need for additional pumped storage capacity to meet the increase in demand for peak electrical power that was forecast; (2) the suitability of the Stanley Works property for a pumped storage plant and its identification as such by the utility industry over many years; (3) hydroelectric power plants regularly are constructed in spite of some adverse environmental effects; and (4) environmental opposition to the construction of a pumped storage plant on the Stanley Works property would, in our opinion, not likely have been so great as to preclude its licensing or construction.

Respondent's argument that there was little, if any, anticipated need for additional pumped storage plants in the

NEPOOL region is not supported by the evidence. Although demand for peak electrical power had declined during the years following the Arab oil embargo, demand had not diminished entirely. In 1977, NEPOOL was forecasting the need for an additional 5,500 megawatts of peak electrical capacity. Respondent's expert conceded that an additional 2,000 megawatts would be necessary by the 1990's. Respondent's contention that the additional demand would be supplied by the Caanan Mountain or Sheffield plants is not persuasive because by 1977 Northeast Utilities already had abandoned its plans to build those plants.

Citing *Powelson*, respondent argues that there was no reasonable probability the Stanley Works property would have been developed as a pumped storage site because any developer thereof would have had to acquire a site for the upper reservoir from an unrelated party. In *Powelson*, the landowner was denied compensation based on a special use valuation of his riparian land because he failed to demonstrate a reasonable probability that his land could be assembled with four other parcels to facilitate the construction of a hydroelectric power plant. Respondent's argument is not supported by the facts of this case. Although a developer of petitioner's property in the instant case would have had to acquire additional property for the site of the upper reservoir, there were several possible sites and there is no evidence to suggest that it would have been unreasonably difficult to acquire such property.

The Stanley Works property was topographically suitable for development of a pumped storage plant. Its rejection by Northeast Utilities and by the NERBC study does not indicate that there was no interest in so developing the property. Northeast Utilities is only one of many utility companies in the region. We also place little significance on the rejection of the Stanley Works property in the 1973 NERBC study. The rejection of the property therein erroneously was based on the environmental impact of constructing a 2,100-megawatt plant, rather than an 800-megawatt plant for which the property was suitable. Moreover, the expert witnesses of both parties agreed that the NERBC study contained many errors and was not conducted in a professional manner. As stated, the record makes it abundantly clear that the Stanley Works property was identified and considered for many years as a potential site for the construction of a power plant.

Environmental opposition to the construction of a pumped storage plant on the Stanley Works property would not likely have been so great that the FPC would have denied a license for construction of the plant. In 1977, the FPC almost never declined to license a power plant on the basis of environmental factors alone. Expert testimony established to our satisfaction that the environmental effects of damming the river could have been mitigated. The Appalachian Trail could have been moved 200 feet to the west, with the result (according to the testimony) that the view of the river actually would have been enhanced from the new location. Animal life also could have been relocated, and whatever archeological or historical artifacts were located on the property (the significance and extent of which are not established in the record) could have been unearthed and relocated as well. The only potential adverse environmental impact to the river that could not have been mitigated would have been the elimination of one whitewater section of the river that was popular with local canoeists.

Respondent relies strongly on *Great Northern Nekoosa Corp. v. United States, supra*, and argues that, as in that case, the prospect of Federal protection of the Housatonic River under the Wild and Scenic Rivers Act was sufficient to make improbable any development of a hydroelectric power plant on the Stanley Works property. The environmental measures and concern that eventually foreclosed development of the riparian lands on the Allagash River in *Great Northern Nekoosa Corp.*, however, were far greater than were the measures and concern applicable to the Housatonic River. Indeed, at the time the gift was made in that case, State laws already had prohibited construction of all hydroelectric power plants on the Allagash River. Moreover, the prospect of Federal control of the Allagash River under the Wild and Scenic Rivers Act was almost certain to occur because Congress had invited the State of Maine to include the Allagash River in the Federal river protection system and there was great public support therefor. In the instant case, the State of Connecticut had enacted no similar legislation to protect the Housatonic River, nor was any planned, and Federal protection of the Housatonic River was unlikely due to limited local support therefor.

The moratorium imposed on development of the Stanley Works property in 1977 as a result of the Federal study of the Housatonic River would not have been a significant deterrent to the construction of a pumped storage plant on the property. As we have said, in spite of the Federal study, inclusion of the Housatonic River in the Federal river protection system was unlikely. Also, because of the long lead time required in the construction of a power plant (including a lengthy licensing period before any construction can begin), the moratorium extending through 1982 would not significantly have affected the value of the Stanley Works property.

Finally, we are unable to conclude that local opposition to development of the Stanley Works property would have been so great as to make reasonably improbable the construction of a power plant thereon. There is little evidence in the record as to the reasons Northeast Utilities withdrew its plans to construct power plants on the Canaan Mountain and Sheffield sites. Although local citizens favored some environmental protection of the Housatonic River by State and local agencies, there is no credible evidence that such interest likely would have prompted local opposition to a pumped storage plant on the Stanley Works property sufficient to force abandonment of such a project.

In light of our conclusion that (immediately prior to the donation in 1977 of the easement in question) there did exist a reasonable probability that the Stanley Works property would be used as the site for construction of a pumped storage plant in the reasonably near future, we now must determine the proper decrease in the value of the property as a result of the donation of the easement which precluded any such development. Petitioner presented alternative methods of valuing the property because no comparable sales exist. As indicated, respondent did not present any evidence on the value of the property with respect to its potential use as a pumped storage facility.

In our opinion, none of the methods used by petitioner's experts to determine the value of the property before the easement was donated are completely reliable. The first method (producing a value of $13 million) was based on a comparison of land acquisition costs with total project costs. All sites were treated as comparable to the Stanley Works property in spite of obvious differences in size and location, among other things. The second method (producing a value of $5,394,000) was based on an estimate in the 1963 study of the value of the Stanley Works property adjusted for inflation, but there was no evidence presented on which we reliably can conclude that the 1963 study by Connecticut Light & Power Co. correctly estimated the value of the property. The third method (producing a value of $8,384,040) is derived from an average per-acre price for land used in the construction of pumped storage plants in the New England region, increased by a 20-percent premium which petitioner contends a hypothetical buyer would pay because he would be able to acquire all the necessary land from one seller. The per-acre price paid for pumped storage land produces a reasonably reliable guide to the value of the Stanley Works property. The premium, however, for assemblage is not appropriate herein because a hypothetical buyer of the Stanley Works property would be required to acquire land for the upper reservoir from parties unrelated to Stanley Works.

After the easement was donated, the parties agree that the Stanley Works property essentially was suitable only for use as farmland and the only evidence in the record concerning the value of Connecticut farmland in 1977 indicates a value therefor of $800 per acre, which produces a value for the Stanley Works property after the easement of $1,680,000.

In our judgment and opinion and considering all the facts and circumstances herein, we hold that the value of the conservation easement donated by petitioner to the HVA was $4,970,000. That amount reflects simply our mathematical calculation of the value of the easement after concluding, as we do, that the value of the Stanley Works property on June 10, 1977, before the donation in question, was $6,650,000.

Our calculation of the value of the easement is reflected below, along with the figures submitted therefor by each of the parties and their experts.

	Before value of property	*After value of property*[1]	*Value of easement*
Petitioner's tax return	---	---	$12,000,000
Respondent's notice of deficiency	---	---	619,700
Petitioner's first value	$13,000,000	$1,680,000	11,320,000
Petitioner's second value	5,394,000	1,680,000	3,714,000
Petitioner's third value	8,384,040	1,680,000	6,704,040
Respondent's value[2]	---	1,680,000	1,100,000
Court's finding	6,650,000	1,680,000	4,970,000

[1] As explained, the parties agree that the Stanley Works property after the easement was donated was suitable only for use as farmland, and the only evidence in the record concerning the value of the farmland suggests a value of $800 per acre, or a total value for the 2,100 acres involved herein of $1,680,000.

[2] As previously stated, respondent contends that the Stanley Works property had no potential to be used as the site for construction of a pumped storage plant, and respondent therefore did not offer evidence concerning the before value of the Stanley Works property.

Our conclusion regarding the value of the easement is based primarily on our finding that the Stanley Works property in 1977 did have a reasonable likelihood to be developed as the site for a pumped storage plant in the reasonably foreseeable future and on our consideration of the values submitted with respect thereto by petitioner's experts. Essentially, we have adopted petitioner's expert's third method of valuing the Stanley Works property, which is based on the average per-acre price for land purchased for a pumped storage plant. We have declined to add to that per-acre price, however, a 20-percent premium for assemblage.

Increased Interest Rate on Substantial Underpayments

The second issue presented by this case raises an issue of first impression.[10] Section 6621(d) imposes an increased interest rate on underpayments of tax (or portions thereof) that are determined to be substantial and to be related to tax motivated transactions. The increased interest rate applicable under section 6621(d) is 120 percent of the interest rate otherwise applicable to income tax deficiencies under section 6621(b). Where applicable, the increased interest rate provided in section 6621(d) applies to all tax deficiencies outstanding after December 31, 1984. Deficit Reduction Act of 1984, sec. 144(c), Pub. L. 98-369, 98 Stat. 682.[11]

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[10] *Solowiejczyk v. Commissioner*, 85 T.C. 552 (1985), presented a similar but different issue concerning whether the increased interest rate under sec. 6621(d)(3)(A)(i) could apply to tax deficiencies relating to years before 1982 in light of the fact that sec. 6659(c), which was incorporated into sec. 6621(d)(3)(A)(i), applies only to tax returns filed after Dec. 31, 1981. We held in *Solowiejczyk*, that the increased interest rate under sec. 6621(d)(3)(A)(i) could apply to a tax deficiency relating to 1978. *Solowiejczyk* did not address the question presented herein of whether the exception set forth in sec. 6659(c)(2) (as applicable to tax returns filed before

The transactions that generally will be considered to be "tax motivated transactions" under section 6621(d) are set forth in section 6621(d)(3)(A). Respondent asserts that subparagraph (i) of section 6621(d)(3)(A), describing a valuation overstatement, is applicable to the facts of this case.

1985), for property that had been held by the taxpayer for more than 5 years, was incorporated into the definition of a "valuation overstatement" in sec. 6621(d)(3)(A)(i).

[11] Sec. 6621(d) provides, in relevant part, as follows:

SEC. 6621(d). INTEREST ON SUBSTANTIAL UNDERPAYMENTS ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.—

(1) IN GENERAL.—In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).

(2) SUBSTANTIAL UNDERPAYMENT ATTRIBUTABLE TO TAX MOTIVATED TRANSACTIONS.—For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

(3) TAX MOTIVATED TRANSACTIONS.—

(A) IN GENERAL.—For purposes of this subsection, the term "tax motivated transaction" means—

(i) any valuation overstatement (within the meaning of section 6659(c)),

(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

(iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092), and

(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period.

(B) REGULATORY AUTHORITY.—The Secretary may by regulations specify other types of transactions which will be treated as tax motivated for purposes of this subsection and may by regulations provide that specified transactions being treated as tax motivated will no longer be so treated. In prescribing regulations under the preceding sentence, the Secretary shall take into account—

(i) the ratio of tax benefits to cash invested,

(ii) the methods of promoting the use of this type of transaction, and

(iii) other relevant considerations.

(C) EFFECTIVE DATE FOR REGULATIONS.—Any regulations prescribed under subparagraph (A)(iv) or (B) shall apply only to interest accruing after a date (specified in such regulations) which is after the date on which such regulations are prescribed.

Section 6621(d)(3)(A)(i) does not define a "valuation overstatement." Instead, section 6621(d)(3)(A)(i) incorporates the definition of "valuation overstatement" that is contained in section 6659(c).

Petitioner argues that under the provisions of section 6659(c) (as applicable to tax returns filed before 1985) property held for more than 5 years, by definition, cannot be the subject of a valuation overstatement. Because petitioner has held the Stanley Works property for over 50 years, petitioner concludes that the increased interest rate applicable to valuation overstatements is not applicable. Respondent argues that under the provisions of section 6659(c), either as originally enacted or as amended in 1984, the definition of a "valuation overstatement" does not include any exception for property held for more than 5 years. Thus, respondent concludes that the understatement of tax attributable to the overvaluation of the Stanley Works property is subject to the increased interest rate of section 6621(d).

As originally enacted in the Economic Recovery Act of 1981, sec. 722(a), Pub. L. 97-34, 95 Stat. 172, section 6659(c) provided as follows:

> SEC. 6659(c). VALUATION OVERSTATEMENT DEFINED.—
>
> (1) IN GENERAL.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).
>
> (2) PROPERTY MUST HAVE BEEN ACQUIRED WITHIN LAST 5 YEARS.—This section shall not apply to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years.

Section 6659(c)(1) and (c)(2) was made applicable only to tax returns filed after December 31, 1981. Economic Recovery Tax Act of 1981, sec. 722(a).

In 1984, section 6659(c) was amended (Deficit Reduction Act of 1984, sec. 155(c)(1)(A), *supra*), and paragraph (2) of subsection (c) (namely, the exception for property held for more than 5 years) was eliminated. Section 6659(c) in its amended form simply provides as follows:

> SEC. 6659(c). VALUATION OVERSTATEMENT DEFINED.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Section 6659(c) as amended was made applicable only to tax returns filed after December 31, 1984. Deficit Reduction Act of 1984, sec. 155(d)(2), *supra.*

As indicated above, petitioner contends that the original version of section 6659(c) (namely, the first version set forth above) applies to the tax deficiency determined in this case and therefore that the exception provided in paragraph (2) of original section 6659(c) for property held for more than 5 years is applicable.

On the surface, petitioner's argument is appealing. The reference in section 6621(d)(3)(A)(i) is simply to "any valuation overstatement within the meaning of section 6659(c)." Section 6659(c), as originally enacted, was entitled, "Valuation Overstatement Defined," followed by two paragraphs—the first of which contained a general explanation of a mathematical percentage that would constitute a "valuation overstatement," and the second of which contained the exception for property held for more than 5 years. Petitioner argues that because the title or heading of section 6659(c) uses the word "Defined," all statutory language that follows the heading is part of the "definition" and therefore that the provisions of both paragraphs (1) and (2) of section 6659(c) were incorporated into the cross-reference made in section 6621(d)(3)(A)(i) to valuation overstatements.

Petitioner also argues that it would be anomalous if the increased interest rate under section 6621(d) with respect to underpayments of tax attributable to tax motivated transactions was applicable to a tax underpayment in a situation where the addition to tax under section 6659 for valuation overstatements concededly did not apply. Lastly, petitioner argues that the internal structure of section 6659 does not support respondent's narrow interpretation of the definitional language of section 6659(c). Petitioner points out that specific limitations on the application of the section 6659 addition to tax are set forth in subsection (d) of that section.[12] Petitioner therefore argues that if the exception for property held for more than 5 years was intended by Congress only as a limitation on the application of the addition to tax for valuation overstatements, the language reflecting that exception would have been included in section 6659(d), not in the definitional language of section 6659(c). For the reasons explained below, we do not agree with petitioner's interpretation of the relevant statutory provisions.

The general cross-reference (pertaining to valuation overstatements) in section 6621(d)(3)(A)(i) to subsection (c) of section 6659, without distinguishing between paragraphs (1) and (2) thereof, easily can be explained by the change in the language of section 6659(c) which occurred simultaneously with the enactment of section 6621(d). Section 6621(d) was enacted as part of the Deficit Reduction Act of 1984 (sec. 144(a), *supra*). As explained previously, section 6659(c) also was amended at the same time. Paragraph (2) of section 6659(c) was removed from the statutory language and old paragraph (1) of section 6659(c) was merged into the flush language of subsection (c). See Deficit Reduction Act of 1984, sec. 155(c)(1)(A), *supra*. Thus, in 1984 when Congress chose to incorporate into section 6621(d)(3)(A)(i) the definition of a valuation overstatement as found in section 6659, it simply referred to the language of section 6659 which contained that definition as it survived the 1984 amendment. More simply stated, in light of the 1984 amendment made to section 6659(c), there no longer was a paragraph (1) or (2) thereof to which reference could be made in section 6621(d)(3)(A)(i). We therefore reject petitioner's argument that in making reference to section 6659(c) in section 6621(d)(3)(A)(i), Congress intended to incorporate into that cross-reference not only the definitional language of section 6659(c) that survived the 1984 amendment thereto but also the language of paragraphs (1) and (2) of section 6659(c) as it existed before the 1984 amendment. We, however, do not base our conclusion herein solely or even primarily on the above analysis.

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[12] Sec. 6659(d) provides as follows:

SEC. 6659(d). UNDERPAYMENT MUST BE AT LEAST $1,000.—This section shall not apply if the underpayment for the taxable year attributable to valuation overstatements is less than $1,000.

Petitioner's various arguments each start with the erroneous assumption that the original version of section 6659(c) controls herein because the amended section 6659(c) applies only to tax returns filed after 1984, and because the understatements of tax at issue herein relate to a tax return filed before 1985. Petitioner's assumption, however, neglects to recognize the effective date provision of the original section 6659(c). If one carries petitioner's assumption (that the original section 6659(c) applies herein) to the next logical step, petitioner's error becomes obvious.

If, as petitioner argues, the effective date provision of the 1984 amendment to section 6659(c) is incorporated into the cross-reference to that section in section 6621(d)(3)(A)(i), logic would dictate that the effective date provision of section 6659(c), as originally enacted in 1981, also would be incorporated into the cross-reference to that section in section 6621(d)(3)(A)(i). Thus, if petitioner's argument were correct, the increased interest rate provided under section 6621(d)(3)(A)(i) never would apply to tax returns filed before 1982 because, as explained, original section 6659(c) does not apply to tax returns filed before 1982. Such a result is contrary to the clear legislative purpose of section 6621(d). The effective date provision of section 6621(d) makes the increased interest rate thereof applicable to all interest accruing after December 31, 1984, *regardless of the date the tax return was filed*. H. Rept. 98-861 (Conf.), 1984-3 C.B. (Vol. 2) 1, 239; *Solowiejczyk v. Commissioner*, 85 T.C. 552, 556 (1985). We thus conclude that the only version of section 6659(c) that was incorporated into section 6621(d)(3)(A)(i) is that version which survived the 1984 amendment to section 6659(c). Since, as explained, that version has no exception for property held for more than 5 years, petitioner's holding of the Stanley Works property for many years has no bearing on the application of the increased interest rate under section 6621(d)(3)(A)(i).

Even if we were to agree with petitioner that the original version of section 6659(c) is the controlling language in deciding whether a valuation understatement occurred under section 6621(d)(3)(A)(i) with respect to tax returns filed before 1985, we still would reject petitioner's argument. Our reading of section 6659(c) (as originally enacted[13]) supports our conclusion. In spite of the heading of that subsection, we think it clear that only paragraph (1) thereof contained the definition of a "valuation overstatement." Paragraph (2), by its terms, contained no language pertaining to the definition of a valuation overstatement, but only an exception to, or a limitation on, the application of the addition to tax for valuation overstatements. We emphasize that the heading of section 6659(c) is just that—a heading. Paragraph (1) thereof is a complete sentence and stands on its own as a definition of a valuation overstatement. Paragraph (2) of section 6659(c), by its terms, operates as a limitation not just on paragraph (1), but on all of section 6659. Thus, although we agree with petitioner that paragraph (2) of section 6559(c) might more appropriately have been made a part of subsection (d) of section 6659, than a part of subsection (c), that fact does not change our conclusion as to the purpose or nature of section 6659(c)(2).

Apropos to the instant question of statutory interpretation, the Supreme Court previously has said—

> headings and titles are not meant to take the place of the detailed provisions of the text. Nor are they necessarily designed to be a reference guide or a synopsis. Where the text is complicated and prolific, headings and titles can do no more than indicate the provisions in a most general manner; to attempt to refer to each specific provision would often be ungainly as well as useless. As a result, matters in the text which deviate from those falling within the general pattern are frequently unreflected in the headings and titles. Factors of this type have led to the wise rule that the title of a statute and the heading of a section cannot limit the plain meaning of the text. *United States v. Fisher*, 2 Cranch 358, 386; *Cornell v. Coyne*, 192 U.S. 418, 430; *Strathearn S.S. Co. v. Dillon*, 252 U.S. 348, 354. For interpretative purposes, they are of use only when they shed light on some ambiguous word or phrase. They are but tools available for the resolution of a doubt. But they cannot undo or limit that which the text makes plain. [*Brotherhood of Railroad Trainmen v. Baltimore & O. R. Co.*, 331 U.S. 519, 528-529 (1947).]

See also *Application of Magnus*, 299 F.2d 335, 337 (2d Cir. 1962).

We agree with petitioner that it is somewhat anomolous that although both section 6621(d) and section 6659 apply to "valuation overstatements," under respondent's interpretation of the relevant statutory provisions (with which we agree), the increased interest rate under section 6621(d) will apply to the facts of this case but the addition to tax under section 6659 will not apply. That result, however, is explained by the different effective date provisions of the two statutory provisions and the different way in which the two effective date provisions operate.

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[13] Hereinafter, unless otherwise indicated, references to sec. 6659(c) will be to that section as it was enacted in 1981 and as it remained until it was amended in 1984.

Our conclusion that the definitional cross-reference in section 6621(d)(3)(A)(i) to section 6659(c) should not be interpreted to include the exception for property held for more than 5 years is further supported by the broad regulatory authority given to the Treasury under section 6621(d) and by the temporary regulations promulgated thereunder. Section 6621(d)(3)(B) gives the Treasury authority, by regulation, to add to the categories of transactions that, under section 6621(d), will be treated as tax motivated transactions. Under that broad grant of authority, on December 26, 1984, the Treasury promulgated Temporary Regulations, sec. 301.6621-2T, Proced. & Admin. Regs., T.D. 7998, 49 Fed. Reg. 50391 (Dec. 28, 1984); 1985-1 C.B. 368, which address certain questions and answers that are likely to arise under section 6621(d). Question 2 of the temporary regulations asks, "What is a tax motivated underpayment?" The relevant portion of the answer provided in the temporary regulations makes it clear that Treasury concluded that the exception provided in section 6659(c) for property held for more than 5 years did not in any way limit the definition of valuation overstatements for purposes of section 6621(d). The relevant portion of the temporary regulations provides as follows:

> Q-2. What is a tax motivated underpayment?
>
> A-2. A tax motivated underpayment is the portion of a deficiency (as defined in section 6211) of tax imposed by subtitle A (income taxes) that is attributable to any of the following tax motivated transactions:
>
> (l) Any instance in which the value of any property, or the adjusted basis of any property, claimed on a return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (i.e., a valuation overstatement *within the meaning of section 6659(c)(1)*); * * *
>
> [49 Fed. Reg. 50391 (Dec. 28, 1984); 1985-1 C.B. 369. Emphasis added.]

By its specific reference in the temporary regulations only to paragraph (1) of section 6659(c), the Treasury clearly announced its decision to interpret the definition of valuation overstatements for purposes of section 6621(d) as excluding the language of paragraph (2) of section 6659(c) and made it clear that valuation overstatements would be subject to the increased interest rate of section 6621(d), regardless of how long the property had been held. The authority of the Treasury to so interpret section 6621(3)(A)(i) by regulation cannot seriously be doubted in light of the broad regulatory authority delegated to the Treasury under section 6621(d)(3)(B).

In light of the above analysis, we conclude that the exception in section 6659(c)(2) for property held for more than 5 years does not apply to valuation overstatements under section 6621(d)(3)(A)(i). We so hold. Because the easement in question was claimed on petitioner's tax return to have a value of $12 million and because that claimed value is in excess of 150 percent of the value we have determined therefor, the increased interest rate under section 6621(d) will apply to the underpayments of tax redetermined herein.

Decision will be entered under Rule 155.

ZETA BETA TAU FRATERNITY, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9419-78. Filed August 13, 1986.

Petitioner is a national college fraternity and is classified by respondent as a tax-exempt social club under sec. 501(c)(7), I.R.C. 1954. *Held*: Petitioner does not also qualify as a domestic fraternal organization under sec. 501(c)(10), I.R.C. 1954. Therefore, petitioner's unrelated business taxable income includes income from investments under sec. 512(a)(3)(A), I.R.C. 1954. *Held, further*, sec. 1.501(c)(10)-1, Income Tax Regs., is valid.

Harold R. Bucholtz, for the petitioner.

Lawrence D. Garr, and *George J. Blaine* for the respondent.

SWIFT, *Judge*: In a timely statutory notice of deficiency respondent determined a deficiency in the unrelated business income tax of petitioner for its taxable year ending June 30, 1971, in the amount of $1,936. The only issue for decision is whether petitioner, a tax-exempt social club described in section 501(c)(7),[1] also qualifies as a tax-exempt domestic fraternal society described in section 501(c)(10). If so, petitioner's income from investments is not taxable as unrelated business income and petitioner is not liable for an underpayment of tax.

FINDINGS OF FACT

This case was submitted fully stipulated under Rule 122, Tax Court Rules of Practice and Procedure. At the time of filing the petition herein, petitioner maintained its principal office in New York City.

Petitioner was organized as a New York corporation in 1907. Petitioner is the central organization of the Zeta Beta Tau national college fraternity (hereinafter referred to as Zeta Beta). Associated with Zeta Beta are approximately 80 local chapters. Also associated with Zeta Beta are approximately 80 corporations (hereinafter referred to as the house corporations) that individually own each building in which the local fraternity houses are located. Zeta Beta also operates the Zeta Beta Tau Foundation, Inc., and the NPEF Foundation, Inc. Zeta Beta, its associated local chapters, and the house corporations were granted tax-exempt status by respondent in 1940 under the provisions of section 101(a), Internal Revenue Code of 1939, the predecessor to section 501(c)(7).

Under the provisions of its national constitution and code of rules, the officers and directors of Zeta Beta's governing body, the supreme council,[2] are selected by representatives of the local chapters who meet annually at a national convention. The supreme council meets periodically and acts as the legislative, executive, and judicial authority of Zeta Beta. Zeta Beta also employs an administrative staff. The principal purpose of Zeta Beta's central staff is to serve as the coordinating and governing organization of the local chapters, house corporations, and private foundations that comprise the Zeta Beta national college fraternity.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

[2] The supreme council consists of Zeta Beta's president, two vice presidents, a treasurer, secretary, 10 alumni directors, and 5 undergraduate directors.

Zeta Beta also provides various programs, services, and publications to the local chapters, their members, and the house corporations. The services and publications provided by Zeta Beta include a philantrophic and social service programming guide, a dance marathon guide, a fraternity magazine, awards to local chapters and members for scholastic and public service achievements, information concerning scholarship and emergency student loan programs, a leadership school for undergraduate members, and a monthly newsletter containing articles on professional schools, study tips, financial aid information, and social news from local chapters throughout the United States. Zeta Beta itself does not engage in any significant social activities.

Each local chapter of Zeta Beta adopts its own constitution and bylaws and generally exercises substantial autonomy in the governance of its affairs. The local chapter may not, however, adopt any rule that contravenes Zeta Beta's constitution or code of rules. Generally, each local chapter does not incorporate as a separate entity. Each chapter, however, files its own annual Federal tax returns (Forms 990, Return of Organization Exempt from Tax). The assets, liabilities, receipts, and expenses of local chapters are not included on Zeta Beta's Federal tax returns. Zeta Beta also does not file a separate group information return with respondent on behalf of local chapters.

Each house corporation associated with Zeta Beta is separately incorporated and serves as the owner and manager of the local fraternity house. The house corporations individually file annual Federal tax returns (Forms 990), and Zeta Beta does not include the assets, liabilities, receipts, or expenses of the individual house corporations in its Federal tax returns. Each house corporation is, however, subordinate to Zeta Beta and subject to its general supervision.

The Zeta Beta Tau Foundation, Inc. (hereinafter referred to as the ZBT Foundation) provides scholarship and loan assistance to undergraduate students who belong to the fraternity. The ZBT Foundation also issues fellowship grants to graduate students in return for their management advice to local chapters of Zeta Beta. The NPEF Foundation, Inc., supports Zeta Beta research and publication programs, chapter house libraries, and leadership development workshops. Both the ZBT Foundation and the NPEF Foundation are recognized by respondent as exempt from Federal income taxes under section 501(c)(3).

As of 1985, Zeta Beta had approximately 104,500 members, of which 4,500 were undergraduate college students and 100,000 were alumni members. Zeta Beta's local chapters provide the undergraduate student members of Zeta Beta housing and meals, social activities, and opportunities for charitable service within their communities. Usually, only a portion of the members of a local chapter reside at the fraternity house. Local chapters generally provide daily meals to their members.

Social activities of each chapter typically include homecoming weekend for alumni and parents, a fall "football weekend," a winter carnival, and a formal dance in the spring. Depending on budgetary considerations and the calendar of social events sponsored by the college, local chapters sponsor additional social events at the fraternity house. The costs of the social events typically are borne by individual members of the chapter.

Local chapters of Zeta Beta also participate in public service activities, such as blood drives, Easter Seal drives, and the transportation of elderly citizens to the polls on election day. Some local chapters regularly sponsor an annual dance marathon to raise funds for charity.

Local chapters of Zeta Beta compete with other college fraternities in scholastic achievement. Chapter members help each other adjust to college life and generally aid in each other's personal development. At times, upperclassmen and graduate student members of Zeta Beta assist and supervise other members of Zeta Beta in their studies. Most Zeta Beta fraternity houses contain a library for use by members. Of the approximately 100,000 alumni, approximately 5,100 contributed money in 1984 to Zeta Beta. An additional 600 alumni participated in Zeta Beta activities in 1984.

The parties agree that Zeta Beta and its subordinate local chapters operate under the lodge system and do not pay insurance benefits to members within the meaning of section 501(c)(10). Zeta Beta concedes that (together with its subordinate local chapters and house corporations) it is a national college fraternity within the meaning of section 1.501(c)(10)-1, Income Tax Regs.

On August 18, 1972, Zeta Beta filed a Return of Organization Exempt from Tax (Form 990) for its taxable year ended June 30, 1971. On June 15, 1973, Zeta Beta filed its Exempt Organization Business Income Tax Return (Form 990-T) for its taxable year ended June 30, 1971. In November of 1975, Zeta Beta filed with respondent an application for a determination that it was tax exempt as a domestic fraternal society under section 501(c)(10). Zeta Beta's application was denied on June 26, 1976. In his letter denying the application, respondent noted that Zeta Beta had "always operated * * * exclusively for educational, charitable, or fraternal purposes," but that as a national college fraternity, it was precluded from tax exemption under section 501(c)(10) by section 1.501(c)(10)-1, Income Tax Regs.

On July 8, 1976, Zeta Beta protested respondent's denial of its application for tax-exempt classification as a domestic fraternal society under section 501(c)(10), and requested reconsideration thereof. On September 30, 1977, respondent reaffirmed his denial of Zeta Beta's application. Respondent's notice of deficiency at issue herein followed.

Respondent's computation of the deficiency herein is based on his inclusion in Zeta Beta's unrelated business income the investment income Zeta Beta received in its taxable year ending June 30, 1971.

OPINION

Generally, tax-exempt organizations described in section 501(c) are taxed at regular corporate rates on unrelated business income. Sec. 511(a).[3] The term "unrelated business taxable income" is defined as the gross income derived from any unrelated trade or business regularly carried on by an organization, less allowable deductions that are directly connected with the conduct of the trade or business. Sec. 512(a). In general, investment income such as dividends, interest, annuities, royalties, rents derived from real property, and capital gains, are excluded from the exempt organization's unrelated business income. Sec. 512(b)(1).

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[3] An exception is made for Government instrumentalities described in sec. 501(c)(1) which are not subject to the tax on unrelated business income provided in sec. 511(a).

Unrelated business income is described differently, however, for, among other organizations, tax-exempt social clubs described in section 501(c)(7). In the case of a section 501(c)(7) social club, unrelated business taxable income includes all income generated by the organization other than "exempt function income" less expenses related to exempt function income. Sec. 512(a)(3)(A).[4] Exempt function income is defined as the gross income derived from dues, fees, charges, or similar amounts received from organization members or their guests for goods, facilities, or services in furtherance of the tax-exempt purposes of the organization. Sec. 512(a)(3)(B).[5] The result of this difference in the computation of unrelated business taxable income is that investment income of section 501(c)(7) social clubs is taxed as unrelated business income, whereas investment income of section 501(c)(10) fraternal organizations generally is not taxed as unrelated business income. See *South End Italian Independent Club, Inc. v. Commissioner*, 87 T.C. 168 (1986); see generally B. Hopkins, The Law of Tax Exempt Organizations, sec. 18.4, at 309-310 (1983).

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[4] Also subject to the special rule provided in sec. 512(a)(3)(A), as currently in effect, are voluntary employees' beneficiary associations under sec. 501(c)(9), supplemental unemployment compensation trusts under sec. 501(c)(17), and group legal services plans under sec. 501(c)(20). Sec. 512(a)(3)(A) provides:

> (3) SPECIAL RULES APPLICABLE TO ORGANIZATIONS DESCRIBED IN SECTION 501(c)(7) OR (9).—
>
> (A) GENERAL RULE.—In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (ll), and (12) of subsection (b). * * *

[5] Sec. 512(a)(3)(B) provides:

> (B) EXEMPT FUNCTION INCOME.—For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by, such organization computed as if the organization were subject to paragraph (l)), which is set aside—
>
> (i) for a purpose specified in section 170(c)(4), or
>
> (ii) in the case of an organization described in section 501(c)(9), to provide for the payment of life, sick, accident, or other benefits,
>
> including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

Zeta Beta, as the central organization of a national college fraternity, received its long-standing tax exemption under the predecessor of section 501(c)(7). Zeta Beta argues, however, that it also properly may be classified as a domestic fraternal society under section 501(c)(10), and that its investment income, therefore, should not be subject to the unrelated business income tax.

Section 501(c)(10), a new category of tax-exempt organizations that was added to the Internal Revenue Code by the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487 (hereinafter sometimes referred to as the 1969 Act), provides a tax exemption for—

> (10) Domestic fraternal societies, orders, or associations, operating under the lodge system[6]—
>
> (A) the net earning of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and
>
> (B) which do not provide for the payment of life, sick, accident, or other benefits.

Treasury regulations relating to section 501(c)(10) expressly state that national college fraternities do not qualify under section 501(c)(10). Section 1.501(c)(10)-1, Income Tax Regs., provides as follows:

> Certain fraternal beneficiary societies.
>
> (a) For taxable years beginning after December 31, 1969, an organization will qualify for exemption under section 501(c)(10) if it—
>
> (1) Is a domestic fraternal beneficiary society order, or association, described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and
>
> (2) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.
>
> *Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section.* [Emphasis added.][7]

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[6] The term "operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. Sec. 1.501(c)(8)-1, Income Tax Regs.

[7] Sec. 1.501(c)(10)-1, Income Tax Regs., was promulgated on Mar. 1971, and given retroactive effect. T.D. 7172, 1972-1 C.B. 141.

Zeta Beta argues that it is an organization that is precisely described by the language of section 501(c)(10) because it is a fraternal society that operates under the lodge system, it does not provide insurance benefits to members, and because its net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes. Zeta Beta further argues that it cannot be distinguished factually from organizations such as the Masons, Moose, or Elks clubs which usually are classified by respondent as tax exempt under section 501(c)(10). Zeta Beta, therefore, contends that section 1.501(c)(10)-1, Income Tax Regs., in its exclusion of national college fraternities from tax exemption under section 501(c)(10), establishes an arbitrary distinction that discriminates between two similarly situated taxpayers (namely, national college fraternities and organizations such as the Masons) and is, therefore, to that extent invalid.

Zeta Beta also contends that its classification as a tax-exempt organization described in section 501(c)(7) does not preclude its additional classification under section 501(c)(10). Zeta Beta concludes that if it meets the precise description of a section 501(c)(10) organization, there is no express or implied legislative policy that would deny it an exemption thereunder just because it also may be classified as a section 501(c)(7) social club.

Respondent argues that Zeta Beta is not an organization described in section 501(c)(10) because of the clear congressional intent that national college fraternities be exempt from tax as social clubs under section 501(c)(7). Respondent contends that national college fraternities such as Zeta Beta are fundamentally different from those fraternal organizations, such as the Masons, that Congress intended to qualify for tax exemption under section 501(c)(10). Finally, respondent argues that even if a national college fraternity could qualify for tax exemption under section 501(c)(10), the net earnings of Zeta Beta herein are not exclusively devoted to the exempt purposes listed in section 501(c)(10)(A). For the above reasons, respondent argues that Zeta Beta properly may be classified only as a section 501(c)(7) tax-exempt social club.

After careful review of the relevant statutory provisions, the legislative history thereof, and the facts of this case, we agree with respondent that a national college fraternity such as Zeta Beta may not properly be classified as a domestic fraternal society described in section 501(c)(10).

Contrary to Zeta Beta's contention, the relevant statutory language is not clear and unambiguous. As we recently stated—

> Trying to understand the various exempt organization provisions of the Internal Revenue Code is as difficult as capturing a drop of mercury under your thumb. There are currently 23 categories of exempt organizations under section 501(c) and five categories of organizations recognized as qualified donees of tax deductible contributions under section 170(c). Rarely is it clear that an organization would qualify only under one of the categories of section 501(c), and often it is clear that an organization would qualify under a number of the categories, even though a particular organization may have applied for and actually received its exemption letter under a single provision of section 501(c). * * * [*Weingarden v. Commissioner*, 86 T.C. 669, 675 (1986).]

There is an extensive body of legislative history explaining the changes in 1969 to the unrelated business income tax provisions of the Code and of the addition of paragraph 10 to section 501(c). A decision herein based solely on the statutory language would be based on a mere "toss of the coin." Reference to the relevant legislative history, on the other hand, provides significant insight into the relevant statutory language. Under such circumstances, we would be remiss if we were to ignore such assistance. See *United States v. American Trucking, Associations, Inc.*, 310 U.S. 534, 543-544 (1940); *J.C. Penney Co. v. Commissioner*, 312 F.2d 65, 68 (2d Cir. 1962), affg. 37 T.C. 1013 (1962); *Lastarmco v. Commissioner*, 79 T.C. 810, 826 (1982).

As explained, the tax exemption for domestic fraternal organizations in section 501(c)(10) had its genesis in the Tax Reform Act of 1969 and arose specifically out of the imposition of the unrelated business income tax on investment income of membership organizations described in section 501(c)(7) and (c)(9). Congress recognized that a tax-exempt social club or similar group organized for recreational or social purposes merely was an extension of the individual members and that it would be inappropriate to impose a tax on the social club as a separate entity. S.

Rept. 91-552 (1969), 1969-3 C.B. 423, 429. One court summarized the rationale as follows:

> Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate entity. The funds exempted are received only from the members and any "profit" which results from overcharging for the use of the facilities still belongs to the same members. No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants. * * * [*McGlotten v. Connally*, 338 F. Supp. 448, 458 (D. D.C. 1972).]

Where, however, the tax-exempt membership organization receives investment income and uses the tax-free income to pay for recreational services offered to its members, the members receive an unintended benefit. As explained in the Senate committee report—

> where the organization receives income from sources outside the membership, such as income from investments (or in the case of employee benefit associations, from the employer), upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation (or other benefits) to its membership. For example, if a social club were to receive $10,000 of untaxed income from investment in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose. [S. Rept. 91-552, *supra*, 1969 C.B. at 470.]

The House report accompanying the Tax Reform Act of 1969 notes similar concern with respect to fraternal societies, as follows:

> The receipt of untaxed income by fraternal beneficiary societies for use in providing recreational or social facilities in furtherance of the organization's fraternal purpose creates a similar problem to that of social clubs. * * * [H. Rept. 91-413 (1969), 1969-3 C.B. 199, 231.]

Congress recognized, however, that investment income also could be used by tax-exempt membership organizations to further the exempt purposes of the organizations and that in such cases the tax on investment income would be inappropriate. Accordingly, the statutory exception found in section 512(a)(3)(B)(i) and (ii) for such income was enacted. As originally proposed by the House, only investment income of fraternal beneficiary associations and employees' beneficiary associations would have been eligible to qualify for this exception. In the Senate Finance Committee, however, the House version was changed to include investment income of social clubs where the investment income of social clubs was set aside for educational or charitable purposes. The Senate committee report explains the change as follows:

> In extending the exemption, the committee intends in the case of *national organizations of college fraternities and sororities* that amounts set aside for scholarships, student loans, loans on local chapter housing, leadership and citizenship schools and services, and similar activities, be classified as amounts used for educational or charitable purposes under this provision. * * * [S. Rept. 91-552, *supra*, 1969 C.B. at 470. Emphasis added.]

The express reference in the above legislative history to investment income of "national organizations of college fraternities and sororities," makes it very clear that Congress considered the investment income of such organizations to be generally subject to the new unrelated business income tax provisions.

In the general explanation of the 1969 Act issued in 1970 by the Joint Committee on Taxation it was expressly noted that the tax on investment income would apply to national organizations of college fraternities and sororities, unless the investment income thereof is set aside for certain educational or charitable purposes. Staff of Joint Comm. on Taxation, 91st Cong., 1st Sess., General Explanation of the Tax Reform Act of 1969, at 70 (J. Comm. Print 1970).

In 1976, Congress reiterated its intention that national college fraternities be tax exempt under the provisions for social clubs described in section 501(c)(7). Certain amendments were made in 1976 to section 501(c)(7), not germane to the issue herein, concerning the scope of a social club's exempt activities and the discriminatory practices of some social clubs. Act of September 28, 1976, Pub. L. 94-568, 90 Stat. 2697. In the committee report explaining those amendments, national college fraternities were expressly identified as the types of organizations described in section 501(c)(7), as follows—

> The House-passed bill, H.R. 1144, amends the requirements for tax exemption for *social clubs and similar organizations (including college fraternities and sororities)* in two respects. * * * [S. Rept. 94-1318 (1976), 1976-2 C.B. 597. Emphasis added.]

That same committee report refers to national college fraternities and sororities several additional times in connection with their tax-exempt classification under section 501(c)(7). For example:

> In addition, the 1969 Act extended the unrelated business income tax, in the case of these social clubs *and national organizations of college fraternities and sororities*, to cover investment income as well as unrelated business income. * * * [S. Rept. 94-1318, *supra*, 1976-2 C.B. at 598. Emphasis added.]

and—

> It is intended that a social club, *national organization of a college fraternity or sorority*, and any other organization exempt under section 501(c)(7), may receive the full 35-percent amount of its gross receipts from investment income sources * * *. [S. Rept. 94-1318, *supra*, 1976-2 C.B. at 599. Emphasis added.]

Petitioner's reliance on *Smith v. Commissioner*, 28 B.T.A. 422 (1933), *Elmira Bank & Trust Co. v. McGowan*, an unreported opinion (W.D. N.Y. 1955, 54-2 USTC par. 10,959), affd. sub nom. *Marine Midland Trust Co. v. McGowan*, 223 F.2d 408 (2d Cir. 1955), and *Langfitt v. United States*, 321 F. Supp. 360 (W.D. Pa. 1970), is misplaced. In *Smith v. Commissioner, supra*, the taxpayer donated to a college fraternity a gift of money which was held to be deductible under the predecessors of sections 170(c)(4) (which provides a deduction for gifts to domestic fraternal societies) or 170(c)(2) (which provides a deduction for gifts to other types of tax-exempt organizations, including social clubs). The opinion in *Smith* does not make clear whether the fraternity involved in that case was held to qualify as a charitable donee under section 170(c)(4), section 170(c)(2), or both, and thus it is not helpful herein.

The District Court in *Elmira Bank & Trust Co. v. McGowan, supra*, held that a donation to a college fraternity's academic scholarship fund was a deductible charitable contribution under section 2055(a)(3) and described the fraternity as a "fraternal society." The Second Circuit, in affirming the District Court, however, did not describe the fraternity specifically as a "fraternal" organization under section 2055(a)(3), as opposed to one of the other categories of qualified donee organizations under that section.

In *Langfitt v. United States, supra,* the District Court treated a college fraternity as a tax-exempt social or recreational organization and a related educational trust fund as an exempt educational organization. Neither the fraternity nor the trust fund was treated as a fraternal organization under section 2055(a)(3).

The above cases involved taxable years prior to 1969, the year in which the substantial amendments were enacted to the statutory provisions at issue herein, and they are not particularly helpful in deciding whether a national college fraternity can qualify for its tax exemption under section 501(c)(10). Similarly, obsolete Treasury regulations cited by Zeta Beta[8] which refer to national college fraternities as being within the general category of "fraternal beneficiary societies," are not controlling because they pre-date the substantial 1969 amendments to sections 501(c) and 512.

Zeta Beta's emphasis on its similarity to section 501(c)(10) organizations such as the Masons also is not persuasive. Clearly, like the Masons, Zeta Beta operates under the lodge system and its local chapters engage in some activities that concedely further the charitable and educational goals of the fraternity. We agree with respondent, however, that the predominant purpose of Zeta Beta and its local chapters is to provide housing, board, and social activities for its undergraduate student members. In that respect,

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[8] Zeta Beta relies on obsolete Treasury Regulation sec. 49.4243-1, Facilities and Services Excise Tax Regs., which provides:

> In the case of a fraternal society, order, or association, operating under the lodge system, or a local fraternal organization among the students of a college or university, all amounts paid as dues or membership fees, as initiation fees, or for life memberships are exempt from the tax imposed under section 4241. The phrase "operating under the lodge system" means carrying on activities under a form of organization that comprises local branches, chartered by a parent organization and largely self governing, called "lodges," "chapters," or the like. For example, an organization formed for purely social purposes by Masons of the higher degrees, consisting of local "lodges" and a "grand lodge," falls within the exemption. A "chapter" of a college fraternity and a "local" of a labor union are also within the exemption. * * * [26 Fed. Reg. 561 (Jan. 20, 1961).]

Zeta Beta is fundamentally different from fraternal organizations such as the Masons.

Even if we could find no relevant distinction between the purposes and activities of Zeta Beta and the Masons, it is not for this Court to counteract by judicial decision what we conclude is the congressional intent to treat national college fraternities in a manner different from fraternal organizations such as the Masons. Congress has "broad latitude in creating classifications and distinctions in tax statutes." *Regan v. Taxation With Representation of Washington*, 461 U.S. 540, 547-548 (1983).

Zeta Beta argues that its existing tax exemption under section 501(c)(7) does not preclude it from receiving an additional tax-exempt classification under section 501(c)(10), if it meets the qualifications thereof. As we stated earlier, in some situations an organization may qualify for tax exemption under a number of paragraphs of section 501(c). We have concluded, however, that national college fraternities are intended by Congress to be treated as exempt under section 501(c)(7) and not under section 501(c)(10).

Zeta Beta concedes that college fraternities historically have been granted tax-exempt classification under section 501(c)(7). If Congress had intended in 1969 to change that policy and to allow national college fraternities to be exempt under section 501(c)(10), it is reasonable to conclude that some mention of such a policy change would have been made in the extensive legislative history that accompanied the passage of the Tax Reform Act of 1969. To the contrary, that history (as well as the legislative history accompanying the 1976 amendments to section 501(c)(7)) reiterates the long-standing treatment of national college fraternities as tax-exempt organizations under section 501(c)(7) and the predecessors therof.

We also note the agreement among commentators that national college fraternities and sororities are tax-exempt social clubs described in section 501(c)(7) and are subject to the unrelated business income tax on investment income. See, e.g., P. Treusch & N. Sugarman, Tax-Exempt Charitable Organizations, ch. 3, sec. E2.03 at 128 (1983); B. Hopkins, The Law of Tax-Exempt Organizations, sec. 18.1, at 303 (1983).

The prohibition in section 1.501(c)(10)-1, Income Tax Regs., on national college fraternities obtaining their tax exemption under section 501(c)(10) is a valid and reasonable interpretation of the statutory provisions as explained above. Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the language, history, and purpose of a statute. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Kampel v. Commissioner*, 634 F.2d 708, 711 (2d Cir. 1980), affg. 72 T.C. 827 (1979).

In light of the congressional intent that national college fraternities qualify for their tax-exempt status under section 501(c)(7), and not section 501(c)(10), we agree with respondent that Zeta Beta is not an organization described in section 501(c)(10), and that Zeta Beta is taxable on its investment income under section 512(a)(3)(A).

Accordingly,

Decision will be entered for the respondent.

ILLINOIS GRAIN CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 6332-84. Filed August 18, 1986.

P, a nonexempt cooperative, derived certain income from interest on short-term loans and from barge rents, which R determined was income from nonpatronage sources within the meaning of subch. T, I.R.C. 1954. Under the facts, *held*, that the income was from patronage sources. *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (1980), and *Cotter & Co. v. United States*, 765 F.2d 1102 (Fed. Cir. 1985), construed and followed.

Arthur E. Bryan, James L. Malone III, and *George W. Benson*, for the petitioner.

Janet Engel, for the respondent.

KÖRNER, *Judge*: For the short fiscal period June 1, 1979, through February 29, 1980, respondent determined a deficiency of $1,595,926 of corporate income tax against petitioner. After concessions by both sides, the issues which we must determine are (a) whether certain income earned by petitioner in the taxable period constituted income from patronage sources within the meaning of subchapter T,[1] and (b) if not, whether such income is subject to reduction by any offsetting expenses attributable thereto in amounts in excess of those allowed by respondent.

FINDINGS OF FACT

Many of the facts herein were stipulated, and such stipulations are incorporated herein by this reference.

At the time of the filing of its petition herein, petitioner corporation (hereinafter petitioner or IGC) had its principal office and place of business at Bloomington, Illinois. Petitioner's tax return for the period here involved was filed on the accrual basis with the Internal Revenue Service at Kansas City, Missouri.

During its taxable year beginning June 1, 1979, and ending February 29, 1980 (FY 1980), IGC was a corporation operating on a cooperative basis within the meaning of section 1381(a)(2), as amended. Prior to IGC's FY 1980, it operated with a fiscal year ending May 31. IGC's fiscal year 1980 was a 9-month taxable year, since, effective March 1, 1980, IGC combined with FS Services, Inc. (which on that date changed its name to Growmark, Inc.) and was then included in Growmark's consolidated Federal income tax return.

During FY 1980 and all of its prior taxable years, IGC was engaged, on behalf of its member and nonmember patrons, in the purchase, distribution, and sale of grains, principally corn and soybeans, and the provision of certain ancillary services in connection therewith. With respect to its member patrons, IGC operated on the cooperative basis. With respect to its nonmember patrons, IGC operated on a noncooperative or commercial basis. During FY 1980, IGC had as member patrons approximately 187 local cooperatives located principally in Illinois and 8 regional grain cooperatives located principally in the midwest. IGC's local cooperative members were farmers' cooperative associations which stored, purchased, conditioned, and sold grains for their farmer members on a cooperative basis.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

Membership in petitioner was limited to agricultural producers or associations of agricultural producers meeting the requirements and operating in accordance with the Agricultural Marketing Act of 1929 or the Capper-Volstead Act. Each member of petitioner entered into a uniform membership agreement with petitioner which provided that petitioner would, among other things: (1) Make its facilities and services available to a member company on the same equitable basis and manner as to other member companies signing similar agreements; (2) assist member companies in the selection of management personnel; and (3) furnish member companies with various advisory and consulting services. The member company, in turn, agreed that it would: (1) Operate within the provisions of the Capper-Volstead Act or the Agricultural Marketing Act of 1929; (2) use every reasonable effort to utilize the facilities and services of petitioner to the fullest possible extent; (3) offer petitioner the opportunity to purchase all of the grain marketed by the member company, except grain sold locally; and (4) comply with certain requirements pertaining to annual audits, management selection, and use of trademarks. The membership agreement did not bind the member to sell its grain to petitioner, nor did it specify the amounts or timing of grain which would be offered for sale through petitioner.

Nonmember patrons, of course, had no such membership agreement with petitioner. Sales of grain offered by nonmember patrons were commingled and handled in the same manner by petitioner as sales for member patrons, except that no patronage refund or dividend was paid to nonmember patrons with respect to their business.

As part of its total grain marketing program, petitioner performed various services for its members. These services included furnishing members advisory and consulting services, information and data, specialized and technical business analysis, market information, hedging assistance, merchandising and storage-use programs, and other assistance to help the members improve their operations. Petitioner's advisory services included reviewing members' financial positions and providing members with a comparative analysis of all the member companies as a basis to measure their own performance. The purpose of these member service functions was to assist members in improving their operations so that petitioner would be able to purchase more grain from them, which, in turn, would enhance petitioner's market position and its ability to service members.

With respect to its nonmember patron business, petitioner retained the earnings from such business and paid income tax thereon. During FY 1980, petitioner calculated that its business with members accounted for 65.62 percent of its total grain purchases, and its business with nonmembers accounted for the remaining 34.38 percent of its grain purchases. The division between member and nonmember patronage income was determined on this basis.

In order for petitioner to maximize the return it could get for marketing its patrons' grain, it was necessary that it be organized and operated in an efficient manner and that it find markets for the grain.

The grain which petitioner marketed for its patrons was sent to market either by rail or through a river barge system operating down the Illinois and Mississippi Rivers. Some of petitioner's patrons, located principally in central and eastern Illinois, were too far from the Illinois and Mississippi Rivers to be able to deliver grain economically to petitioner's river terminals. These patrons were served by petitioner's "track and processor" merchandising operations. In its fiscal year 1979, petitioner opened a new grain terminal at Paxton, Illinois, to service these patrons. The terminal was located at the intersection of two railroads, and patrons' grain could be shipped from there by rail either to the Gulf Coast or the East Coast for export. During FY 1980, petitioner leased approximately 400 covered railroad hopper cars to provide an assured supply of railroad cars for transportation to connect the Paxton terminal with export terminals on the Gulf and East Coasts. Having control of rail equipment is an important part of merchandising grain through rail terminals.

In the 8 full fiscal years immediately preceding the short fiscal year in issue, the annual volume of petitioner's grain sales ranged from just under 160 million bushels to just under 318 million bushels. During this period, approximately 60 percent of the grain marketed by petitioner went through the river barge system. Ever since the late 1940's, the core of petitioner's grain marketing business was its river system. The river system was keyed to utilizing the advantages of economical river transportation to provide Illinois farmers an access to world markets. In addition to the numerous country grain elevators in Illinois owned by petitioner's members, petitioner owned six subterminal elevators on the Illinois River. Two terminal elevators on the Mississippi River in St. Louis, Missouri, were owned and operated by St. Louis Grain Corp. (SLGC), an interregional grain marketing cooperative of which petitioner was the principal member patron, and an export elevator in Ama, Louisiana, was owned by Farmers Export Co. (Farmers), another interregional grain exporting cooperative in which petitioner was a member patron. Additionally, in FY 1980, petitioner was the second largest member patron of Agri-Trans Corp. (ATC), an interregional barging cooperative owned by five regional cooperatives. ATC barged grain south for its four grain member cooperatives, down the Illinois and Mississippi Rivers to New Orleans, and barged fertilizer back to the Midwest for the fifth member, a cooperative fertilizer manufacturer. ATC satisfied about 45 to 50 percent of petitioner's barging needs. For a grain company such as petitioner, with river terminals, barging is an integral part of grain merchandising. Without direct or indirect control of barges, such a grain merchandiser is at the mercy of the market. Consequently, the ability to have an assured source of supply of barges was very important for petitioner. In prior years, petitioner and its predecessors had been adversely affected by barge shortages and had taken some steps to gain control over barges. This was done by leasing barges to barge companies who were then willing to commit a greater number of barges to move petitioner's grain. To assure a source of barges to move grain from its Illinois River terminals, in 1958, petitioner entered into an arrangement with its then principal supplier of barge transportation (The Mechling Co.), a manufacturer of barges (Dravo Corp.), and an insurance company (Northwestern Mutual Life Insurance Co.), which called for the construction of four barges by Dravo, which were financed by the insurance company as owner, leased to petitioner pursuant to a long-term bareboat charter, and subchartered to Mechling, which then used those barges and others to move petitioner's grain. Petitioner originally entered into the bareboat charter arrangement with Northwestern Mutual Life Insurance Co. because petitioner was short of capital. The arrangement permitted petitioner to acquire the barges without incurring additional long-term debt.

Prior to 1967, petitioner had shipped a substantial amount of its grain through the Great Lakes and the St. Lawrence Seaway, using a terminal which it then owned in the area of Chicago. In 1967, petitioner disposed of its Chicago terminal and thereafter concentrated its efforts on shipping grain by barge south to New Orleans. Shipments down the Illinois and Mississippi Rivers increased dramatically, so that by its 1975 fiscal year, petitioner loaded approximately 1,300 barges of grain on the Illinois River.

After disposing of its Chicago terminal, petitioner caused its four barges to be subchartered to whichever firm was then the principal supplier of barge services to petitioner. In 1973, petitioner subchartered the barges (of which three remained in operation) to Rose Barge Line. At the time, Rose was the largest hauler of petitioner's grain to the Gulf. When ATC was formed in 1974, it purchased substantially all of the assets of Rose and also succeeded to the subcharter between petitioner and Rose. The subcharter to ATC was subsequently renewed as to the barges (of which two remained in operation) and remained in effect in FY 1980.

Although petitioner could not control the specific use which ATC made of these barges under the subcharter, ATC used the subcharter barges plus its other barges to transport petitioner's grain from petitioner's river terminals to New Orleans. In FY 1980, petitioner relied on ATC to supply it with approximately half its barging needs. Petitioner regarded the barges it subchartered to Rose and later to ATC as an extension of its river system. In FY 1980, the two barges leased by petitioner to ATC comprised a small part of the ATC fleet of eight tow boats and 335 barges. In that year, ATC carried approximately 1,200 barge loads of grain for petitioner, at a cost to petitioner in the range of $15 to $25 million. With respect to the two barges subchartered to ATC, petitioner received gross barge rentals of $13,109 in FY 1980. On its books, petitioner did not show the barge rentals as a separate item of income, but simply netted the barge rentals received against the overall transportation costs which it paid to ATC. On its FY 1980 tax return, however, petitioner reported gross income from various rents, among which was the $13,019 from barge rent.

The grain business is extremely competitive, and competition for grain in the areas in which petitioner operated was intense. Petitioner competed with grain processors in Illinois and with the major worldwide grain companies. The principal form of competition was price competition. The major companies in the world grain trade are large private grain firms such as Cargill, Inc., Continental Grain Co., Louis Dreyfus, and Bunge Corp. These are very large companies with access to worldwide capital. For example, Cargill, Inc.'s fiscal 1985 sales were $32 billion. By comparison, petitioner's annual sales in fiscal 1979 were approximately $925 million.

The grain market is also highly volatile, which is the result of many things affecting supply, demand, and price, including seasonal factors, cyclical factors, political factors, and the weather. Seasonal factors affecting the grain business are a result of the fact that grain is harvested at one time of the year and then marketed over a 12-month period. The exact marketing pattern of each year's crop is not predictable.

There is no way for a company in the grain business to insulate itself from the supply, demand, and resultant price volatility that exists in the grain business. The volatility of this business results in grain price fluctuations which have a major impact on grain companies. Grain price fluctuations can result in rapid changes in a grain company's capital requirements. A substantial increase in grain prices can result in significant cash demands upon a company, such as petitioner, as a result of such things as increases in margin requirements and inventory values. A substantial decline in grain prices would have the opposite effect; it would reduce capital needs and provide additional funds to a company such as petitioner. To deal with the volatility that exists in the grain business, a company must build into its financial structure a high degree of flexibility in the form of liquidity in order to fund the changes in its current assets and liabilities.

During the period June 1, 1978, through February 29, 1980, petitioner's assets (current and fixed) varied at monthend from approximately $60 million to more than $100 million. The volatility in petitioner's capital needs arose principally from sharp fluctuations in its current assets (e.g., inventory, accounts receivable, margin deposits, grain sales advances, and cash and short-term instruments). For instance, petitioner's current assets went from approximately $28 million on September 30, 1978, to approximately $66 million on December 31, 1978, and back to approximately $39 million on May 31, 1979. It was essential to the conduct of petitioner's grain marketing business that petitioner have the necessary financial flexibility to be able to finance the highs which it experienced in its capital needs. There were periods of time when petitioner was short of quick cash working capital, as well as other periods in the year when petitioner had temporary surpluses in its working capital. Petitioner was undercapitalized; it lacked an adequate amount of capital to compete effectively with the large international grain companies. Undercapitalization made it potentially more difficult for petitioner to operate on a day-to-day basis.

Petitioner's long-term debt was financed with the St. Louis Bank for Cooperatives (St. Louis Bank). In its FY 1980, such long-term debt fluctuated narrowly in the range between $13.7 million and $14.9 million (using rounded figures). Aside from this long-term debt, petitioner had short-term or current liabilities, principally in the form of notes payable, sales advances, and accounts payable, which fluctuated rapidly during the course of the year, and which generated both deficits and surpluses of working capital at various times. The causes of these fluctuations were both market conditions as well as specific financing programs which petitioner used in aid of its grain-marketing efforts.

The principal causes may be identified and described as follows:

(A) *Deferred Pricing Program*

Petitioner entered into contracts with members which allowed them to sell grain to petitioner, while at the same time allowing the members to defer the time when such grain would be priced for up to 270 days. Petitioner was able to take title to the grain, sell the grain and generate cash, while its obligation to pay for the grain was deferred. Later, when a member elected to price the grain, petitioner was required to make payment *the next day*, provided that in no event was payment due earlier than 60 days after the original transfer to petitioner.

In FY 1980, deferred pricing contracts generated temporary cash for petitioner, since many deferred pricing contracts were entered into in late summer and early fall 1979, and the member companies who entered into these contracts did not price the grain until after January 1, 1980. Although petitioner was initially reluctant to offer a deferred pricing program to its members, it did so to meet competition from other grain companies and to satisfy the demand for such arrangements from its members and from their farmer members. A deferred pricing program made it possible for petitioner to obtain grain at times its members might otherwise be reluctant to sell grain because of their evaluation of the market.

When petitioner sold grain which it had received under the deferred program, it immediately went into the futures market and bought a futures contract. Petitioner was then short in cash grain, because it had sold the grain, and it was long on the futures market. In this way, petitioner was able to hedge its position. Ordinarily, prices in the futures market are higher in March than in November. This increase reflects storage carrying charges for grain and the cost of money to hold the grain from November until March. To offset the storage carrying charge built into the cost of hedging, petitioner charged members a service charge for deferred pricing transactions. To offset the cost of money factor built into the cost of hedging, petitioner was able to use the cash generated by the transaction.

(B) *Hedging Activities*

It was the policy of petitioner to sell grain on a hedged basis as much as was practical. Hedging is an integral and necessary part of the business of any grain marketing company. Petitioner entered into contracts to purchase grain and contracts to deliver grain and then hedged the open cash-grain commitments in the futures market to minimize its vulnerability to losses from price fluctuations. For hedging purposes, petitioner used the services of Illinois Cooperative Futures Co. (ICFC), cooperative headquartered in Chicago, which executed futures contracts on the Chicago Board of Trade for its members. ICFC's membership included 104 regional and local cooperatives, including petitioner. It was necessary for petitioner to make an initial margin deposit on each futures contract it bought or sold when it hedged on the Chicago Board of Trade. As the market price of grain changes every day, petitioner was required either to make additional margin deposits, or margin money was returned to petitioner. Petitioner normally was long on grain and short in the futures market. When the price of grain increased, petitioner was normally required to increase its margin deposits. When the price of grain decreased, margin deposits were returned to petitioner.

In FY 1980, petitioner's hedging activities generated cash as margin money was released. This was the result of petitioner's smaller inventory and of price movements in the market. In a 10-day period during June 1979, there was a $10 million swing in amounts required to be put up by petitioner as margin for its hedging activities. Petitioner regarded the conditions leading to the reduction of its margin requirements as temporary in nature, and did not know how long they would last.

(C) *The Member Note Program*

Petitioner believed that it was in its members' best interests to use *their* temporary surplus working capital in a way which would maximize the amount that they could return to their farmer members. In addition, petitioner was concerned that member company funds were not always safe when, as was often the case, they were left in small-town banks. In response to this situation, in the early seventies, petitioner developed a member note program. Offering the member note program to its members was one of the service programs which petitioner provided its members, similar to hedging and other service programs. It also provided petitioner with a source of short-term funds.

The member note agreements provided that petitioner would hold the members' funds for a minimum term of 15 days and a maximum of 270 days. Petitioner paid the member a fixed rate of interest which ordinarily was set at two percentage points below the prime rate of interest at the time the note was issued. A member could redeem its note upon demand for cash any time after the 15th day.

Petitioner's members increased the amount of member notes they placed with petitioner in the fall of 1979 over previous years. The same conditions that left petitioner with temporary surplus working capital during this period also left petitioner's members with temporary surplus working capital. The member company note program generated a significant amount of cash for petitioner in FY 1980, particularly during the period petitioner had temporary surplus working capital from other sources.

(D) *Inventories*

Petitioner's inventories decreased in July and August 1979. Inventories moved upward in September and October, but not in as great an amount as was expected during a normal harvest period. Inventories dropped further in November and December and then increased in January and February 1980. When inventory quantities or values decreased, funds were freed up in petitioner's business. Declines in the quantities and value of petitioner's inventory contributed to its temporary surplus working capital during the last part of FY 1980.

(E) *Earnings*

Petitioner generated small earnings during the early portion of its FY 1980. As petitioner got into the harvest period, however, it generated substantial earnings from August through December. There was a reduction in earnings in January of about $1 million as a result of the

Russian grain embargo, and a slight recovery in February. Earnings were one source for petitioner's temporary surplus working capital position during the last part of FY 1980.

In the management of its capital requirements, petitioner maintained banking relationships with the St. Louis Bank and also with the First National Bank of Chicago (First National Bank). In addition to its long-term debt which it had financed with the St. Louis Bank, petitioner also had a $40-million short-term line of credit from the St. Louis Bank, and a $20-million short-term line of credit with the First National Bank. The rate of interest the St. Louis Bank charged petitioner on short-term and long-term borrowing during the fall of 1979 was 10 percent. On January 1, 1980, the short-term rate moved up to 13 percent while the long-term borrowing rate stayed at 10 percent.

During FY 1980, before the end of the grain market on each day (approximately 1:15 to 1:30 p.m.), petitioner assessed its cash needs for the day. If it required additional cash, it would borrow short-term from one of the two above mentioned banks. If it made this decision before noon, it borrowed funds from the St. Louis Bank. If the need for funds arose later in the day, the funds were borrowed from the First National Bank. Since the Chicago Board of Trade required any additional required margin to be posted within 45 minutes of the closing of the market, it was necessary that petitioner have a banking relationship with a bank located in Chicago. In addition to its needs for funds to meet these requirements, petitioner also felt that it was important to its financial flexibility not to restrict itself to a banking relationship with a single bank.

As a result of all the forces described above, if petitioner found itself in a net positive cash position on a particular day, it would first pay back any short-term borrowings that it had outstanding (e.g., member notes, short-term bank loans). If no short-term borrowings were outstanding, then petitioner would use any temporary surplus working capital to purchase short-term instruments. Occasionally, by miscalculation or mistake, petitioner would use such cash to purchase short-term instruments before all short-term borrowings were paid back. This occurred on only two occasions in FY 1980. Petitioner rarely found itself in a position in which it neither required additional cash nor had temporary surplus working capital.

Beginning on September 7, 1979, and continuing through the end of FY 1980, petitioner was in a position in which it had temporary surplus working capital, in varying amounts. Petitioner used these temporary surpluses to purchase short-term instruments from the First National Bank. It purchased commercial paper of the holding company of the First National Bank, and certificates of deposit of the First National Bank. On a few occasions during FY 1980, petitioner entered into repurchase agreements or purchased Treasury bills through the First National Bank. During FY 1980, petitioner made 136 separate purchases of interest-bearing instruments. Ninety-eight of these transactions, or 72 percent, were overnight or overweekend transactions. Twenty-eight of such purchases, or 21 percent, were for a week or less, mostly overweekend, with an extra day tacked on at one end of the weekend. The remaining 10 transactions were for more than a week. Of these 10, 4 took place in December when petitioner was confident that its member companies would not want their funds until January.

The reason for the high level of overnight transactions was that petitioner did not know when it would need the temporary surplus working capital in its business. Petitioner was making daily judgments that, for the most part, it would need its surplus working capital on its next business day. If petitioner had been willing to purchase short-term instruments with longer maturities, it would have been able to earn a higher rate of interest. The rates of interest for commercial paper were going up during this period of time.

Petitioner never considered using its temporary surplus working capital to pay off any long-term debt. Since its long-term debt agreements with the St. Louis Bank required that any prepayment of principal be applied to the last principal payment due under the note, any such prepayment by petitioner would not have reduced its current level of payments on the long-term debt.

Petitioner likewise never considered leaving its temporary surplus working capital in a non-interest-bearing account, or distributing such excess working capital to its members. Given petitioner's state of under capitalization, and its chronic need for short-term funds, either practice would have been viewed with extreme disfavor by the First National Bank of Chicago as evidencing poor financial management on the part of petitioner. Since the First National Bank was an important source of credit and funds, petitioner considered it important to maintain and strengthen its relationship with the bank.

On its books, petitioner netted its interest income against interest expense. The actual figures on its financial statements for FY 1980 were interest expense of $1,592,000, interest income of $744,000, or net interest expense of $847,000. In its tax return for FY 1980, however, petitioner listed *gross* income from interest from a number of sources, one of which was $585,490.22 from "commercial paper, certificates of deposit, repurchase agreements, treasury notes."

Petitioner's return for FY 1980 treated all its net income as derived from its cooperative grain marketing activity, that is to say, as patronage-sourced income. Petitioner then allocated such income between member business and nonmember business on the basis of the quantity of grain sold for members and the quantity of grain sold for nonmembers. Petitioner then paid patronage refunds to its members in the amount of $3,304,253.04. Of this amount, $663,078.04 was paid in cash and $2,641,175 was paid in petitioner's stock. The patronage refunds paid by petitioner to its members with respect to its fiscal year 1980 were: (a) Paid on the basis of the quantity or value of business done with or for patrons; (b) paid under an obligation of petitioner to pay such patronage refunds, which obligation existed before it received the amount so paid; (c) actually paid on or before the 15th day of the ninth month following the close of FY 1980; and (d) paid entirely in cash and "qualified written notices of allocation," as that term is defined in section 1388(c).

Upon audit of petitioner's return, respondent determined, inter alia, that $213,795 of petitioner's patronage dividend exclusion under section 1382(b) was not allowable because such amount was "attributable to income not derived from patronage sources and therefore is not deductible." Respondent has now agreed that the correct amount of such disallowance should be $143,359. Included in this figure is respondent's determination that the interest which petitioner earned on the short-term debt instruments which it purchased, in the net amount of $324,435, as well as the barge lease income, in the net amount of $7,179, was not derived from patronage sources and accordingly was not eligible for distribution as a patronage refund.

ULTIMATE FINDING OF FACT

The interest income which petitioner received from the purchase of short-term debt instruments, as well as the rentals from its two barges, was derived from business done with or for petitioner's patrons.

OPINION

The principal question which we must decide in this case is whether certain income earned by petitioner was derived from patronage sources within the meaning of subchapter T of the Internal Revenue Code. More specifically, was the income in question derived by petitioner from "business done with or for [its] patrons," within the meaning of section 1388(a)(1)?

The question is of unique importance in the taxation of cooperatives, and of nonexempt or taxable cooperatives in particular. In general, all cooperatives, whether so-called "exempt" cooperatives under section 521, or so-called "nonexempt" or "taxable" cooperatives, are taxed in the same fashion as any other corporation. Secs. 1381(b), 1382(a).[2] Such cooperatives, however, are entitled to certain additional deductions, not available to other taxpayers, in the computation of their net taxable income.[3] Among these additional allowable deductions, available to both exempt and nonexempt cooperatives, is that provided by section 1382(b)(1), which states:

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[2] Certain special types of cooperatives are not included within the ambit of subch. T. Thus, certain mutual savings banks and building and loan associations are taxed under the special provisions of part II of subch. H and certain insurance companies are specially taxed under the provisions of subch. L. Such companies, together with cooperatives furnishing electrical energy or providing telephone service to persons in rural areas, are excluded from the provisions of subch. T. Sec. 1381(a)(2).

> SEC. 1382(b). PATRONAGE DIVIDENDS AND PER-UNIT RETAIN ALLOCATIONS.—In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—
>
> (1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d))) with respect to patronage occurring during such taxable year;* * *(4)

Section 1388(a) defines patronage dividend as follows:

> SEC. 1388(a). PATRONAGE DIVIDEND.—For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies—
>
> (1) on the basis of quantity or value of business done with or for such patron,
>
> (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
>
> (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.
>
> Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done

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[3] "Profits" and "income" are considered somewhat "dirty" words in the cooperative fraternity. Consistent with the broad philosophy that cooperatives are intended to operate at cost, eliminating entrepreneur profit and returning their net earnings to their patrons on an equitable basis (see secs. 1382(b), 1388(a); see also I. Packel, The Organization and Operation of Cooperatives, sec. 2 (4th ed. 1970)), cooperatives tend to eschew the words "profits" and "income," preferring instead the more delicate terms "margins" and "savings." Under the iron rod of the Internal Revenue Code, however, and subch. T in particular, cooperatives do have taxable income, particularly where, as here, the cooperative elects to distribute patronage dividends only to its member patrons. The balance of a cooperative's income, not so distributed to patrons on a patronage basis, sec. 1388(a), is fully taxable, whether patronage-sourced or not.

In *Farm Service Cooperative v. Commissioner*, 619 F.2d 718, 723 (8th Cir. 1980), revg. 70 T.C. 145 (1978), the Court of Appeals said:

"A nonexempt cooperative is a hybrid business organization, taxed like an ordinary corporation with respect to nonpatronage-sourced income (see subchapter C, IRC 301 *et seq.*), but like a partnership with respect to patronage-sourced income. * * * That is to say, nonpatronage-sourced income is fully taxable to the cooperative and, if paid out in dividends to the patron, to him as well. Patronage-sourced income is taxed only once, usually to the patron."

[4] Certain other additional deductions are provided for all cooperatives in sec. 1382(b), and further additional deductions are provided for exempt cooperatives under sec. 1382(c). We are not concerned with those special deductions here.

with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

What, then, is the meaning of the phrase "business done with or for such patron," or, as the synonymous phrase has evolved, "income from patronage sources"? The Code provides no definition, and the legislative history of the subchapter T provisions is not helpful. The sole guidance to be found in respondent's regulations is one which undertakes to define the concept in negative terms, that is to say, by attempting to give a definition of that which is *not* patronage income. Thus, in attempting to define income "from sources other than patronage" under section 1382(c)(2), respondent's regulations provide:

> (2) *Definition.* As used in this paragraph, the term "income derived from sources other than patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage. [Sec. 1.1382-3(c)(2), Income Tax Regs.]

Although the above-quoted language appears in respondent's regulations with respect to a Code provision of exclusive application to exempt cooperatives—section 1382(c)—it appears to be generally accepted that this definitional attempt is of equal application to both exempt and nonexempt cooperatives.

In spite of the apparently clear language of the regulation, however, the law, as it has developed, shows that the language does not always mean what it literally says. Both respondent and the courts have played a hand in this evolution of the law, as we shall see.

Thus, in the case of interest, both the courts and respondent have acknowledged that interest income may have the quality of income from patronage sources, depending upon the circumstances. *Cotter & Co. v. United States*, 765 F.2d 1102 (Fed. Cir. 1985); *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (1980); Rev. Rul. 74-160, 1974-1 C.B. 245. Dividend income has sometimes likewise been held to be patronage-sourced.

Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982); *Linnton Plywood Association v. United States*, 410 F. Supp. 1100 (D. Ore. 1976); Rev. Rul. 75-228, 1975-1 C.B. 278. Rental income has also been held to be patronage-sourced, on occasion. *Cotter & Co. v. United States*, *supra*; Rev. Rul. 63-58, 1963-1 C.B. 109 (semble); and some capital gains income has been held to be income from patronage sources, under the circumstances presented in the particular case. *Astoria Plywood Corp. v. United States*, an unreported case (D. Ore. 1979), 43 AFTR 2d 79-1114, 79-1 USTC par. 9197; contra Rev. Rul. 74-160, 1974-1 C.B. 245.

Is there any touchstone or common thread running through these various cases and rulings which enables them, with their facial inconsistency, to be reconciled with their facial inconsistency with the language of respondent's regulation quoted above? We think it can be found in one of respondent's own pronouncements.

In Rev. Rul. 69-576, 1969-2 C.B. 166, the taxpayer, a nonexempt farmers cooperative, borrowed money from a bank for cooperatives, itself a cooperative. The money was borrowed to finance the acquisition of agricultural supplies for resale by the taxpayer to its members. The taxpayer cooperative paid interest to the bank on this loan. After the close of the year, the cooperative bank determined its net margins or savings from business done with borrowers, and paid to the taxpayer, as a patronage dividend, its ratable and patronage share of the interest income thus earned. The taxpayer cooperative, in turn, included the amount of such patronage dividend in the patronage distribution which it made to its member patrons. In holding that this patronage dividend from the cooperative bank should be considered as patronage-sourced income in the hands of the taxpayer cooperative, respondent ruled:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the

association's cooperative operation, the income is from nonpatronage sources.

Accordingly, inasmuch as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's purchasing activities, it is held that the allocation and payment of this same amount by the nonexempt farmers' cooperative to its own patrons (farmers) qualifies as a patronage dividend. * * *

[Rev. Rul. 69-576, 1969-2 C.B. 167.]

Analysis of the relevant cases under the above standard shows that they can be reconciled. What is revealed is that the courts (if not respondent) have consistently resolved the cases before them, based upon an application of the principles of Rev. Rul. 69-576 to the facts at hand.

In *Astoria Plywood Corp. v. United States*, *supra*, the taxpayer cooperative leased a plant facility in which it conducted its cooperative activity of manufacturing plywood. When the landlord canceled the lease, it made a lease cancellation payment of $50,000 to the taxpayer. Holding that the use of the plant facilities to manufacture plywood was directly related to the taxpayer's cooperative activities, the court held that the income from the cancellation of the lease (arguably to be classified as capital gain income) was nevertheless income from patronage sources and was eligible for distribution as a patronage dividend. In so holding, the court clearly disapproved, without mentioning it by name, the provisions of Rev. Rul. 74-160, *supra*, which held to the contrary.

In *Linnton Plywood Association v. United States*, *supra*, the taxpayer cooperative, together with another cooperative, organized a third corporation, in which the taxpayer owned a 50-percent interest, for the purpose of making glue which the two cooperatives used in their business of making plywood. The court held that the dividends received by taxpayer from the 50-percent-owned subsidiary were patronage-sourced income, since such income was directly related to the cooperative's business, in which glue was an essential element. In this case, it is noteworthy that there was no suggestion that the glue could not have been obtained from any other source.

In *Land O'Lakes, Inc. v. United States, supra*, the taxpayer, a dairy marketing cooperative, borrowed money from the St. Paul Bank for Cooperatives in order to finance its cooperative business. In order to be eligible to borrow from the bank, the taxpayer had to buy a certain amount of stock in the bank. Dividends received on such stock by the taxpayer were distributed to its member patrons on a patronage basis, an action which the Commissioner disallowed on the basis that the dividend income was not patronage-sourced pursuant to section 1.1382-3(c)(2), Income Tax Regs. The court held, however, that the purchase of the bank's stock actually facilitated the cooperative business by making favorable financing available to it, and thus the dividends received were patronage-sourced. In so holding, the court cited with approval and appears to have clearly adopted the rationale of Rev. Rul. 69-576 and Rev. Rul. 74-160.

In *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983), the taxpayer was a nonexempt cooperative, serving as a purchasing, warehousing, and distribution facility for the goods sold by its member patrons. On occasion, when it had temporary surpluses in its cash, above immediate needs, the taxpayer invested such funds in short-term certificates of deposit and earned interest thereon, which it distributed to its member patrons as part of its patronage dividends.

In upholding the Government's disallowance of these distributions on the ground that the interest income was not patronage-sourced, the Claims Court emphasized what it considered to be the lack of a sufficiently direct relationship between the lending of surplus funds and the principal business of the cooperative. Thus, the court found that there was little if any connection between the cooperative's money management and the services which the cooperative provided to its patrons, and that there was no direct connection between the short-term loans and the cooperative activity of buying, storing, and distributing merchandise. The court rejected a test which would have qualified the income as patronage-sourced simply because it was used to enhance the profitability of the business as a whole. In so holding, it seems clear that the court was accepting and following the rationale of Rev. Rul. 69-576, and, in its own wisdom, was applying it to the facts of the case before it.

In *St. Louis Bank for Cooperatives v. United States, supra,* the taxpayer was a nonexempt cooperative bank, whose business was to make loans to other cooperatives. The taxpayer's source of funds, with which it made loans to other cooperatives, in addition to a certain amount of equity capital, was derived from long-term debt which it issued itself and short-term borrowings from the Central Bank for Cooperatives, as well as from commercial banks and from other farm credit banks. During the period in question, its primary source of funds was its long-term debt, and the Central Bank for Cooperatives was relied upon as the primary supplier of short-term borrowings.

The St. Louis Bank was constantly engaged in managing its funds so that it would have sufficient funds on hand to lend to eligible cooperatives. Such needs fluctuated widely on a very short-term basis. The taxpayer attempted to make provision for its necessary funds on a daily basis, but it sometimes resulted that it had a deficit in its necessary available cash, while at other times it found it was in a surplus position with respect to available cash. These surplus or deficit positions resulted from overestimating the needs of its borrowers, or underestimating those needs. Its cash position was rarely in balance, although it was more often in a deficit position than otherwise, and frequently had to borrow funds on a short-term basis.

During the years before the Court, when the taxpayer found it had funds available that were temporarily surplus to its needs, it normally loaned the funds on a demand basis to the Central Bank for Cooperatives or, on several occasions, to other farm credit banks in its district, in compliance with established policy to encourage intersystem use of surplus funds. In a few cases, it loaned funds on a short-term basis to commercial houses under repurchase agreements. Such loans were always on a demand or short-term basis in order to assure availability to the taxpayer in the event it was determined that such funds were needed to cover advances to eligible borrowers.

The taxpayer treated the interest which it made on its short-term loans of the surplus funds as patronage-sourced income, and included it in the amounts which it distributed to its patrons on a patronage basis. The Government took the position that such interest income was not patronage-sourced, in that the loans were not made to the taxpayer's patrons, nor made for them. On the contrary, the Government contended that the placement of the taxpayer's temporary surpluses in short-term and demand instruments was not integrally related to the conduct of the cooperative business and was therefore to be classified as nonpatronage-sourced income not eligible for distribution as patronage dividends.

The Court of Claims rejected the Government's position in this case, and in so doing, clearly embraced the directly related standard of Rev. Rul. 69-576. It held that the taxpayer's placement of temporary surpluses in short-term loans was "integrally intertwined" with the taxpayer's cooperative business of managing its money supply. It held that such short-term placements were not "investments" but simply constituted the prudent and correct management of the taxpayer's money which was directly related to the conduct of its cooperative business. As the court said:

> Interest income from bonds plaintiff held for liquidity purposes is patronage sourced because the transactions involved are directly related to plaintiff's services to its patrons. They were a prerequisite to plaintiff's functions. Unless the bonds were held, plaintiff could not issue consolidated bonds, the primary source of loan funds for its patrons. [*St. Louis Bank for Cooperatives v. United States*, 624 F.2d at 1053.]

Finally, we consider the case of *Cotter & Co. v. United States, supra.* In that case, as in the instant case, the taxpayer had two sources of funds which were challenged as not being patronage-sourced. The taxpayer was a nonexempt cooperative engaged in the business of purchasing, manufacturing, and distributing to its patron members hardware and related goods in large volume. In the conduct of the enterprise, it was essential that the taxpayer have cash available, either through short-term borrowings or cash on hand, in order to finance the volume purchase of goods which it later resold to its patron members. The taxpayer's business was seasonal, in that it made many of its purchases throughout the year, frequently some time before it resold the goods to its members. Because its payments to its suppliers were frequently due before it received funds from its members, it was required to maintain substantial liquidity either from short-term borrowings or from cash on hand. It happened that at many times during the year, the taxpayer had a working capital deficit, whereas at other times, it had surpluses of cash in excess of its immediate needs. At all times, however, the retention of sufficient liquidity was essential to the proper conduct of its business.

When the taxpayer had temporary surpluses of cash, it followed the practice of paying down short-term loans or prepaying bills. When these measures had been exhausted, it followed the practice of placing its temporary cash surpluses in short-term commercial paper. The Claims Court found that the taxpayer's money management practices in this respect were directly related to its cooperative activity and were an inseparable part thereof. The Government, however, disallowed the interest income earned by the taxpayer from the short-term placement of its funds on the ground that such actions were merely a passive investment of surplus funds, which had no purpose except to enhance the overall profitability of the cooperative. Accordingly, the Government urged (and the Claims Court below found) that the interest income earned by the taxpayer was not patronage-sourced nor eligible for distribution as patronage dividend.

The Federal Circuit reversed the Claims Court in this matter, and in so doing, it clearly adopted the directly related test of Rev. Rul. 69-576, as well as the rationale of the Court of Claims in *St. Louis Bank for Cooperatives v. United States, supra*, and that of the Court of Appeals of the Eighth Circuit in *Land O'Lakes v. United States, supra*. In following the lead of the Court of Claims in *St. Louis Bank*, the Federal Circuit held that the directly related principle employed was not to be applied only to money-management activities of cooperatives engaging in the banking business. As the court said, to allow such a—

> narrow focus, which considers the transaction without regard to the totality of the circumstances, would allow the surgical removal of one of a series of transactions from the economic realities that necessitated it. Consideration of the relatedness of a transaction to a cooperative's function must be undertaken by viewing the business environment to

> which it is arguably related. * * * The activity producing the income may not be so narrowly defined as to limit it only to its income-generating characteristic *when such a characterization is not consistent with the actual activity.* [*Cotter & Co. v. United States*, 765 F.2d at 1106-1107. Emphasis in original.]

The Federal Circuit went on to say:

> Cotter, acting as any reasonable business person, reduces the cost of this money while retaining its necessary availability by keeping short-term commercial paper. Its actions are akin to placing its funds in a bank account. Cotter's activity, viewed in the context of its business activity, cannot be considered an action enhancing overall profitability; merely to enhance profitability Cotter would pay off its debt or take other more profitable action. Rather, Cotter acts to retain its liquidity in a manner of any reasonable business person. Its actions are similar to those undertaken by taxpayer in *St. Louis Bank*. [765 F.2d at 1107.]

The Court of Appeals accordingly held that the incidental interest income earned by the taxpayer cooperative from the short-term placement of its temporary surpluses was directly related to and actually facilitated the cooperative enterprise within the meaning of Rev. Rul. 69-576. As a result, such income was considered as patronage-sourced and eligible for distribution as a patronage dividend.

The second issue involved in the *Cotter* case involved rental income. The taxpayer required substantial amounts of warehouse space, in the conduct of its cooperative business, to store merchandise which it had acquired or manufactured and which it had not yet shipped to its patron members. The business was experiencing rapid growth, and the cooperative realized that it had a need for additional warehouse space, which would increase even further in the future. It accordingly designed and had built, or leased, additional warehouse space, including some excess space which it anticipated it would need in the future. In the meantime, it leased out its temporarily excess warehouse space, and derived some minor rental income therefrom.

Here, as in the case of the interest income, the Government contended that the taxpayer's rental income from leases of excess warehouse space was not directly related to its cooperative enterprise and should be considered as nonpatronage-sourced income, apparently relying on the quoted regulation. The Claims Court upheld the Government's position, but once again the Court of Appeals reversed, saying:

> The rental income earned through the leasing out of temporarily excess space is also patronage sourced. The stipulated facts clearly show that renting temporarily excess space was only a minor component of taxpayer's plan for making certain that Cotter had sufficient warehouse and manufacturing space. Architects do not as yet provide warehouses with accordion pleated walls that may be expanded or contracted in strict conformity to the owner's needs. * * * It is clear from the undisputed facts that Cotter did not go into the warehouse rental business, seeking to enhance corporate profits while hiding behind its label as a cooperative. Indeed, Cotter occasionally must lease space from others as well. Rather, Cotter implemented a reasonable plan to secure the warehousing of its goods at the lowest cost to its patrons; the result is a primary function of Cotter's. [765 F.2d at 1109-1110.]

A review of the statutory provisions, the decided cases in the area and, indeed, respondent's announced position on the subject, as embodied in Rev. Rul. 69-576, leads us to the conclusion that in this case, the petitioner must prevail as to both types of income here in issue. As the cases make clear, such a determination is necessarily fact-intensive. Income derived by a cooperative from its various business activities may indeed be so closely intertwined and inseparable from the main cooperative effort that it may be properly characterized as directly related to, and inseparable from, the cooperative's principal business activity, and thus can be found to "actually facilitate" the accomplishment of the cooperative's business purpose. On the other hand, it is equally possible that a cooperative may undertake business activities which, while profitable, have no integral and necessary linkage to the cooperative enterprise, so that it may fairly be said that the income from such activities does nothing more than add to the taxpayer's overall profitability. It all depends on the facts of each case. In the instant case, we consider the facts with respect to each type of income separately.

1. *The Interest Income*

The facts in this case show that petitioner's principal cooperative enterprise was the marketing of its patrons' grain. The financing of this enterprise was complex and called for petitioner's constant attention and management of its money so as to have available on short notice large amounts of cash to meet margin calls, to repay members' notes, to satisfy patrons' demands under the deferred pricing arrangements which petitioner had with its patrons, and to pay its current bills. On the other hand, petitioner received funds, not entirely on a predictable basis, from sales (reducing its inventories), and from lessening margin requirements (which fluctuated on a daily basis), as well as from its long-term and short-term borrowings. Although petitioner analyzed its cash needs on a daily basis, it could not always be precise. On some days, petitioner had to exercise its short-term line of credit to borrow from the First National Bank or the St. Louis Bank. On other days, petitioner would find itself in a surplus cash position. When the latter event occurred, petitioner, in the exercise of ordinary prudent business management, placed its temporary surplus funds in extremely short-term debt instruments—for the most part, overnight or overweekend loans to the First National Bank, or its wholly owned subsidiary. The primary purpose here was not to "invest," but to find a temporary parking place for its surplus funds, consistent with safety and prudent money management. We do not agree with respondent's contention that such placement of temporary surplus funds in short-term debt instruments constituted an "investment" of such funds, as that term would generally be understood. Petitioner's actions here were entirely comparable to placing the funds in a bank account. One does not make an "investment" in a bank account. The rate of interest which petitioner earned on these extremely short-term placements was less, as we have found, than the interest which petitioner could have earned elsewhere on longer-term debt instruments.

In short, we are convinced that petitioner's money management activities in this case were inseparably intertwined with the overall conduct of its cooperative enterprise, and the interest income which it earned was therefore patronage-sourced, to the same extent as in the *Cotter* and *St. Louis Bank* cases.

2. *The Barge Rental Income*

The facts here show that petitioner relied heavily upon river barges to transport its patrons' grain to market. In fact, in the period before us, over half of petitioner's grain went to market in this fashion. Petitioner operated no barges itself to transport its members' grain, but over the years had relied on various barge companies to perform this service. In order to secure an adequate supply of barges for the transport of its grain, petitioner, some years prior to the year in issue, had caused four barges to be constructed, which it then leased from the Northwestern Mutual Life Insurance Co. as owner, and subleased to whichever barge company was performing the transportation function for it. We assume that it paid the normal transportation costs for the barging of its grain, and that the barge company to whom it subleased its barges likewise paid a fair and arm's-length rental; respondent herein does not contend otherwise.

By the time of the year here in issue, petitioner's four barges had dwindled to two, which were subleased by petitioner to a barge transportation cooperative of which it was a member-patron. Although, as we have found, petitioner did not exercise direct control over the use to which the barges were put, it was clearly in petitioner's interest to see to it that the barge company had an adequate supply of bottoms in which to transport petitioner's grain. We can find no distinction here between petitioner's actions in providing barges to ATC, and its actions in leasing 400 covered railroad hopper cars to provide a supply of such cars for the shipment of its grain by rail, handled by various railroads, a situation as to which respondent has raised no question.

Here, again, as in the case of petitioner's interest income, we are satisfied that petitioner's leasing and subleasing of barges to its transportation cooperative was not an "investment" in such barges, intended to produce merely passive rental income, but was an integral part of its overall cooperative activity in moving its patrons' grain to market. The provision of such barges by petitioner to ATC may not have been a significant factor in the ability of ATC to move petitioner's grain, given the fact that there were only two barges left by the year in issue, but we think it was clearly linked to petitioner's principal cooperative enterprise, and was not entered into as an independent and unrelated profit-making activity. We accordingly hold that the barge rentals which petitioner derived in the year in issue were patronage-sourced income, within the rationale of Rev. Rul. 69-576, and consistent with the philosophy expressed in the *Cotter* case.

In opposition to petitioner's position herein, respondent argues strenuously that the Federal Circuit went too far in *Cotter*, and that the standard enunciated in that case opens the door to a cooperative claiming that any income it earns, from whatever activity, can be qualified as patronage-sourced income simply because it improves a cooperative's overall profitability. Thus, according to respondent, if we follow *Cotter*, every "car wash" or "bake sale" sponsored by a cooperative will produce income from patronage sources, simply because the net proceeds are used in the cooperative's business.

We think that respondent's concerns are considerably overblown. In our view, the Federal Circuit in *Cotter* clearly was aware of the danger of an indiscriminate application of its interpretation of subchapter T. It addressed this concern in these words:

> We agree with the Claims Court that Congress did not intend the ter "with or for patrons" to be "of unlimited scope, [so that] *all* incom produced by cooperatives that is passed through to patrons would be, i essence, income obtained *for* patrons, and would, therefore, be consider patronage sourced." *Cotter*, 6 Cl. Ct. at 227. A cooperative cannot mere "clothe its shareholders as patrons and its corporate dividends a patronage payments" and retain the benefits of Subchapter T. *Missi sippi Valley*, 408 F.2d at 835. But Subchapter T was also not enacted t require that a cooperative acting for its patrons function in an econom cally unreasonable manner or penalize it for acting reasonably. Consid ing the income-generating transaction in its relation to all the activit undertaken to fulfill a cooperative function will allow courts to disti guish from cooperative activity transactions which merely enhan overall profitability in a manner incidental to cooperative function. Suc activity is not to receive the benefits of Subchapter T, but other activity which does directly relate to cooperative function when considered in i actual business environment, cannot properly be considered outsi "business done with or for patrons." * * * [765 F.2d at 1110.]

We repeat that every case of this nature must necessarily turn upon its own facts. The same activities which may be directly related to the cooperative enterprise in one case may not be so directly related in another case. It all depends upon the nature of the cooperative effort, and the way the cooperative conducts its business. In the instant case, we do not think petitioner did anything different with respect to managing its short-term funds than any other business enterprise would have done, consistent with skilled professional money management. Respondent would appear to require that petitioner do something less than this in order to secure the benefits of subchapter T. We do not think the law requires this, and commonsense indeed dictates otherwise. As we said in *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. 729, 736 (1977):

> We consider respondent's position herein not only contrary to the [law], but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives. * * *

Holding in favor of petitioner on the primary issue presented, it therefore becomes unnecessary for us to consider the second issue.

Decision will be entered under Rule 155.

MUNFORD, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 13720-83. Filed August 18, 1986.

During its taxable year ended Dec. 30, 1976, petitioner placed in service an addition to a refrigerated facility for the storage of frozen food products. The addition comprised a 3,900 square foot truck loading platform, a 1,030-square-foot rail loading platform and a 34,650-square-foot refrigerated area. Petitioner sought an investment tax credit under sec. 38, I.R.C. 1954, with respect to costs relating to the addition, contending that the structure constitutes tangible personal property under sec. 48(a)(1)(A). Respondent allowed the credit only with respect to certain refrigeration system components of the refrigerated area. *Held*, the truck loading platform and the rail loading platform are "buildings" and as such, costs relating thereto are not eligible for the credit under sec. 48(a)(1)(A) and secs. 1.48-1(c) and 1.48-1(e), Income Tax Regs. *Held, further*, the refrigerated area of the addition is not a building for purposes of the investment tax credit. *Held, further*: The costs relating to the refrigerated area of the addition are not eligible for the credit other than as allowed by respondent. Neither the structural elements of the refrigerated area, nor the refrigerated area as a whole constitutes "property which is in the nature of machinery" within the meaning of the penultimate sentence of sec. 1.48-1(c), Income Tax Regs.; they are not tangible personal property under sec. 48(a)(1)(A). *Weirich v. Commissioner*, 62 T.C. 446 (1974), distinguished.

Herschel M. Bloom, *Ralph B. Levy*, and *Peter J. Genz*, for the petitioners.

Lourdes M. Desantis and *Donald W. Williamson, Jr.*, for the respondent.

FAY, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax as follows:

Taxable year ended—	*Deficiency*
Jan. 3, 1974	$50,343
Jan. 2, 1975	48,831
Jan. 1, 1976	445,755

After concessions, the issues are (1) whether petitioner is entitled to an investment tax credit under section 38[1] with respect to an addition to a refrigerated storage facility to an extent greater than allowed by respondent, and (2) whether petitioner is entitled to depreciate the addition to the refrigerated storage facility using the 200-percent declining balance method of depreciation under section 167(b)(2) and an 8-year useful life.[2]

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

[2] As tried and briefed by the parties, this case also presented the issue of whether petitioner had properly adjusted its basis in the stock of a wholly owned subsidiary, Farmbest Foods, Inc. (Farmbest), to account for gain or loss upon disposition of such stock during its taxable year ended Dec. 28, 1978. Resolution of that issue was dependent upon the interplay of sec. 312(k) and the provisions of respondent's consolidated return regulations, particularly sec. 1.1502-32, Income Tax Regs. The parties agreed that if petitioner's basis adjustments were correct, petitioner realized a long-term capital loss (net of selling expenses) of $850,582 upon the sale of Farmbest stock, and that, if respondent's basis adjustments were correct, petitioner realized a long-term capital gain of $701,095 upon the sale of such stock. However, subsequent to our decision in *Woods Investment Co. v. Commissioner*, 85 T.C. 274 (1985), in which basis adjustments similar to those used by petitioner were sustained, respondent filed a notice with

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioner, Munford, Inc., had its principal place of business in Atlanta, Georgia, at the time it filed the petition herein.

Petitioner is the common parent of an affiliated group of corporations which filed consolidated Federal income tax returns for all the taxable years in issue. For the taxable year 1971, petitioner filed its consolidated Federal income tax return on a calendar year basis. For taxable years beginning after December 31, 1971, petitioner filed its consolidated returns on a 52- to 53-week basis, with each taxable year ending on the Thursday nearest December 31. Petitioner used the accrual method of accounting.

Petitioner was founded in 1909 as an ice and coal supply company. Petitioner opened its first convenience food store in 1949 and, during the 1950's, expanded its business activities to include the ownership and operation of commercial refrigerated facilities. Petitioner acquired a chain of building material stores in 1962, and opened retail gift stores in 1965. Beginning in 1975, petitioner expanded its operations to include dairy processing divisions. During the years in issue, petitioner was thus engaged in a variety of businesses.

Issue 1. Investment Tax Credit

During its taxable year ended December 30, 1976,[3] petitioner owned and operated 12 refrigerated facilities in the southeastern United States, including a facility located at Xavier Drive, S.W., Atlanta, Georgia (herein the Gateway Facility). During that year, petitioner completed the

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the Court indicating that he no longer wished to pursue his legal arguments concerning the adjustments to the basis of the Farmbest stock. He therein conceded that petitioner did not realize a long-term capital gain of $701,095 upon the sale of the Farmbest stock during its taxable year ended Dec. 28, 1978.

[3] Although the notice of deficiency does not purport to determine petitioner's Federal income tax liability for its taxable year ended Dec. 30, 1976, such period is relevant herein in that petitioner claimed investment tax carryback therefrom to 2 of the years here in issue. See note 5 and accompanying text *infra*. Moreover, although the stipulation of facts refers to the relevant taxable year as ending on Dec. *31*, 1976, other references in the record are to petitioner's taxable year ending Dec. *30*, 1976. This latter date appears to be correct, since it was a Thursday and petitioner used a 52- to 53-week year ending on the Thursday closest to Dec. 31.

construction of, and began operating, an addition to the Gateway Facility (herein the Addition) which is the subject of this proceeding. The Addition, the operation and construction of which are described in greater detail herein, consists of three areas: (1) A refrigerated portion comprising approximately 34,650 square feet, (2) a structure used as a loading dock and staging area for loading and unloading trucks, comprising approximately 3,900 square feet, and (3) a structure used as a covered rail dock for unloading goods shipped by rail, comprising approximately 1,030 square feet.

a. *Operation of Addition*

Since the time it was put into operation, the Addition has been used exclusively by petitioner to receive and store on behalf of frozen food processors, final-processed, packaged frozen foods at low temperature, pending delivery to the customers of such processors in the southeastern United States. These customers consist primarily of grocery store chains and other food service organizations, such as schools and cafeterias. Approximately 150 food processors use the Gateway Facility on a regular basis. All products that arrive at the Addition are packaged and labeled by the processor prior to delivery to the Addition. The Addition is not used either to process or to manufacture frozen foods.

Approximately 25 to 30 percent of the frozen food products stored at the Addition arrive aboard refrigerated railroad boxcars that run along a spur line adjacent to the rear of the Addition. The boxcars are not owned or operated by petitioner. All other frozen food products stored at the Addition arrive by refrigerated tractor trailer trucks operated by independent common carriers.

The Gateway Facility has approximately 50 employees who handle the movement of frozen foods in and out of the entire facility. The movement of food products in and out of the Addition is generally handled by a work crew consisting of a foreman and two or three helpers drawn from the 50 employees.

Upon arriving at the Addition, boxes of frozen foods are removed from the boxcars and from the tractor trailers by petitioner's employees using forklifts, and then counted and placed on pallets. The food products are then stored in the refrigerated area of the Addition on large pallet racks in the same cartons or boxes in which they were shipped by the food processors. Legal title to the frozen foods stored in the Addition is not taken by petitioner, but rather, is retained by the frozen food processors. When frozen food cartons or boxes are unloaded and placed in the refrigerated portion of the Gateway Addition, the frozen food processor receives a credit to the inventory which it has stored in the Addition.

After storage, frozen foods are generally shipped out of the Addition via tractor trailer trucks. When a truck is fully loaded and ready to leave the Addition, its driver signs a bill of lading and assumes the risk of transporting the frozen foods. As part of its service to customers, petitioner arranges for frozen foods to be shipped from the Addition to a 15-State region encompassing all of the southeastern United States. Upon receiving a release from a frozen food processor authorizing a shipment, the traffic department at the Gateway Facility arranges for a commercial trucker to make the delivery. When the refrigerated truck arrives at the Gateway Facility, all merchandise scheduled for delivery to that particular destination or region, regardless of ownership, is culled, grouped, and loaded by forklifts onto the waiting truck. This process is called "consolidation" and is designed to give petitioner's customers the benefit of the cheaper rates charged by truckers for transporting full loads. Petitioner charges its customers a special consolidation fee for this service. Petitioner pays the freight bill on the shipment of goods from the Addition on behalf of the frozen food processors and then bills each processor for its proportionate share of the total freight bill.

When the frozen food cartons or boxes are shipped out of the Addition, the frozen food processor receives a debit to its inventory. To ensure that the oldest merchandise in storage is shipped out first, each pallet of frozen foods is tagged with an inventory control number that allows petitioner's employees, with the assistance of a computerized, first-in, first-out (FIFO) inventory control system, to locate the oldest stored merchandise for each customer. Petitioner charges each processor which stores frozen foods within the Addition a one-time handling and storage fee based on the weight of the stored products. This fee is in addition to any applicable consolidation fee and freight bill reimbursement.

The refrigerated area of the Addition is maintained at a temperature ranging from minus five degrees Fahrenheit (-5 degrees F) to zero degrees Fahrenheit (0 degrees F). Due to the low temperature, petitioner's employees work within the refrigerated area of the Addition only to load and unload frozen foods, take inventory, and perform occasional repairs or maintenance. Because of the cold temperature, they generally do not stay within the area more than 12 minutes at a time. To protect against the cold, the employees wear cold weather gear, including coveralls, parkas, hats, and gloves while working in this area. Such gear is not worn by petitioner's employees when loading or unloading goods from the refrigerated boxcars or trucks.

Petitioner's employees enter and exit the refrigerated area of the Addition almost exclusively on electrically powered forklifts, which are used to move the frozen food products in and out of the Addition. They also generally use forklifts to move about the loading dock areas.

b. *Construction of Addition*

Petitioner hired John W. Freeman (Freeman) and John E. Anderson (Anderson) to design the Addition. Freeman is a structural engineer who has designed approximately 20 commercial refrigerated facilities and about the same number of dry warehouses for various clients, including petitioner. Anderson is a refrigeration engineer who has designed systems for at least 10 commercial refrigeration facilities. In designing the Addition, Anderson and Freeman coordinated their efforts to insure the compatibility of the structure and the refrigeration system.

The foundation of the Addition consists of concrete footings which support the structure. In order not to be affected by the cold temperatures within the Addition, the footings are placed at a depth of 2 to 3 feet below the floor. Above the foundation, there is a system of under-floor ventilation pipes intended to prevent the earth below the structure from freezing; without this system, frost buildup in the fill beneath the Addition would eventually cause the concrete slab floor of the structure to heave and crack. Air is drawn through the ventilation system by fans, and the system can be enhanced if necessary, by forcing heated air through the pipes.

The under-floor ventilation system is covered by a bed of sand. Above the sand bed is a "vapor barrier" consisting of polyethylene laid out in large sheets. The vapor barrier, which extends from beneath the floor and continues vertically inside the walls of the Addition, is intended to prevent moisture from penetrating the Addition. The portion of the vapor barrier located beneath the floor is sealed at the joints to prevent any moisture penetration from the earth, and is covered by 6 inches of low temperature insulation. This insulation was placed directly upon the vapor barrier in two segments, or "boards," which were staggered at the joints to reduce channels for temperature migration.

The floor of the Addition consists of a concrete slab which was poured over the low temperature insulation. Since contraction in the floor could occur as a result of the low temperatures within the Addition, a number of contraction joints were provided in the slab to minimize the possibility of cracking. Moreover, since the slab rests upon low temperature insulation, which is rather compressible relative to normal soil, the slab contains long steel rod dowels inserted in sleeves across the contraction joints in order to maintain proper alignment of the slab surface. Nothing protrudes from the floor surface but concrete curbs which line the base of the walls and act as bumper guards for the forklifts.

The outer walls of the Addition consist of "tilt-up" concrete panels which were cast on site using conventional building materials and tilted into place. At the corners abutting the floor and walls of the structure, the continuity of the polyethylene vapor barrier is maintained. The sheets comprising the vapor barrier extend up along the inside of the walls of the structure and are hung from a point near the top of the walls. The joints of the vapor barrier are sealed.

The vapor barrier is covered within the walls of the Addition by 8 inches of low temperature insulation. This insulation was erected against the walls in two layers, with staggered joints to minimize temperature migration. To protect and provide continuity for the vapor barrier and the insulation, a high strength corner flashing (reinforcement material) is located at the joints where the wall insulation and the floor insulation overlap. Similarly, continuity of the vapor barrier and insulation is maintained by means of overlapped joints at the abutting wall corners of the structure. The insulation layers are covered on the interior of the structure by 5/8-inch type "X" fire-resistant gypsum board. The gypsum board is intended to protect the insulation from damage. In addition, since it is highly flammable, the insulation is required by fire code guidelines to be enclosed in an air tight manner, and the gypsum board also performs this function. The insulation and the vapor barrier are not visible in the finished Addition, and cannot be removed without tearing out the existing wall and floor structures.

The roof of the Addition is constructed of steel decking. In order to maintain continuity of the vapor barrier and insulation at the juncture of the roof and the walls, the roof is not supported by the walls of the structure, but rather, rests upon columns of structural steel located within the Addition near the walls. The gap between the roof and walls is designed to allow the vapor barrier and insulation to "turn the corner" from the walls and continue along the roof without interruption.

The roof has 10 inches of low temperature insulation comprised of two layers. A continuous wood blocking is bolted to the roof deck near the perimeter of the deck (near the upper portion of the walls) and the first layer of roofing insulation is located between the blocking and the wal insulation under compression, forming a tight seal. In addition to the low temperature insulation, the roof also contains two layers of noncombustible insulation board. The lower layer serves to separate the steel deck from the flammable low temperature insulation, and the upper layer was installed principally to allow hot bitumen (asphalt) to be mopped onto the built-up roof without damaging the low temperature insulation. Each layer of insulation board is attached to the low temperature insulation by means o adhesives. The joints of both the noncombustible and low temperature insulation are staggered to reduce channels fo temperature migration. The built-up roofing of the Addition serves as a continuation of the vapor barrier and insulation as found within the walls and beneath the floor of the structure.

The Addition's rail loading platform, approximately 16 feet wide, is located at the rear of the Addition. The platform is used for loading and unloading railroad cars which deliver frozen foods to the Addition. It has a roof, but no outer or side walls, and covers an area of approximately 1,030 square feet.

The Addition's truck loading platform is a raised concrete platform which runs along the front of the Addition. This platform, which is enclosed, but not refrigerated, is 25 feet wide, and covers an area of approximately 3,900 square feet. It has seven exterior roll-up doors, each approximately 8 feet wide, that permit access to the refrigerated trucks. The truck loading platform was constructed at a height sufficient to ease the loading and unloading of products at the dock. It is used as a staging area for loading and unloading refrigerated trucks. It contains sufficient space for consolidating or storing the products, so that frozen foods can be quickly loaded when a common carrier arrives. Petitioner's employees assigned to the Addition spend a substantial part of their workday within the loading platform area. Attached to the platform are seven dock levelers designed to provide a ramp from the back of open tractor trailers onto the loading platform. At the foot of the truck loading platform is a truck loading pad constructed of reinforced concrete which measures 110 feet by 50 feet. This pad is constructed so that the tractor trailer wheels will not sink into the ground when the trucks are being loaded or unloaded.

The refrigerated area of the Addition covers 34,650 square feet. It contains multi-level storage racks with openings sized to accommodate products stacked on pallets and lifted into place by forklifts. The aisles of the refrigerated area are wide enough to accommodate the movement of the forklifts operated by petitioner's employees. Lighting in this area is provided by special low temperature mercury vapor lamps, since normal commercial fluorescent lighting will not work in the low temperatures maintained therein.

The refrigerated area of the Addition is cooled by a system which is controlled from a central "engine room" which services the entire Gateway Facility. The engine room, which was not constructed as a part of the Addition, is designed as a fully automated system and does not require regular supervision. It is, however, monitored on a daily basis by one of petitioner's employees. The engine room has a small work area consisting of a desk and chair, but the noise of the equipment makes it uncomfortable for a person to remain in the engine room for more than a brief period.

Located in the engine room are eight heavy compressors which operate to lower the temperature of ammonia and then pump it through insulated pipes that run along the roof of the Gateway Facility. These pipes are connected to large evaporator units located within each refrigerated area of the Gateway Facility. Three such units are suspended from the ceiling of the Addition. These units, each of which has a cooling capacity of 25 tons British thermal units, force large volumes of air past the frigid ammonia and then direct the cold air into the refrigerated area of the Addition. The evaporator units were moved into the Addition from another portion of the Gateway Facility at the time the Addition was constructed.

When the Addition was constructed, the existing compressors in the engine room had sufficient excess capacity to cool the Addition; thus, no new compressors were added. However, the engine room had to be modified and new ammonia pipelines added in order to accomplish this task. The compressors in the engine room can be removed, but are generally repaired and serviced in place. In the past, one of the compressors was moved from the engine room for repair.

The three evaporator units suspended from the ceiling of the refrigerated area of the Addition, as well as the compressors in the engine room, can be moved without structural damage to the Addition. However, the vent pipes beneath the floor, the low temperature insulation, and the polyethylene vapor barrier cannot be moved without damaging the structure of the Addition.

The Addition has two special compartments, or vestibules, located between the refrigerated area and the truck loading platform. These vestibules function as "air locks" and help prevent the warmer outside air and moisture from entering the refrigerated area. The vestibules are constructed so as to maintain continuity of the vapor barrier and insulation. Each time the outer door of a vestibule opens, the interior of the vestibule receives an influx of warm, moist air. To prevent freezing of this moisture, heat lamps are used in the vestibules to maintain above-freezing temperatures for the inner floor, wall, and ceiling surfaces, as well as the door hinges. At night, the exterior of each vestibule is sealed off by heavy, metal-clad doors containing low temperature insulation. The perimeter of each door contains gaskets which form a seal with the wall insulation. These gaskets also contain heat cables to prevent freezing of condensation which could otherwise cause the doors to jam.

The design and construction of the Addition involve numerous features which would not be found in a conventional or dry warehouse. For example, the concrete footings forming the foundation of the Addition were placed at a depth of 2 to 3 feet below the floor to protect them from cold temperatures within the Addition, whereas footings used in the construction of a dry warehouse would generally be placed at a depth of approximately 8 inches. The underground ventilation system, the doweled construction joints in the floor slab, the vapor barrier, and the extensive low temperature insulation used in the Addition would not typically be found in a dry warehouse, nor would the vestibules found in the Addition serve any purpose in a dry warehouse.[4]

On its consolidated Federal income tax returns for the taxable years ended January 3, 1974, and January 1, 1976, petitioner claimed investment tax credit carrybacks from its taxable year ended December 30, 1976, with respect to $581,437 of costs relating to the Addition. In his notice of deficiency, respondent disallowed the claimed investment tax credit, except with respect to certain refrigeration system components of the Addition, including refrigeration pipes, pipe insulation, valves, and motors, costing in the aggregate $103,470.12.[5] Thus, the costs of the Addition that are at issue in this case total $477,967 (i.e., $581,437 claimed by petitioner, less $103,470 allowed by respondent).[6]

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[4] Although vapor barriers are occasionally used in the construction of dry warehouses, a thinner gauge polyethylene is used in those structures and the seams of the polyethylene sheets comprising the barrier are not sealed.

Issue 2. Depreciation

Petitioner has consistently followed the practice of deducting one-half of the first year's depreciation allowable with respect to its depreciable property in the taxable year in which the property is placed in service. The Addition was completed and began operation during petitioner's taxable year ended December 30, 1976. However, petitioner failed to claim any allowance for depreciation with respect to the Addition for such taxable year. On its consolidated Federal income tax return for the taxable year ended December 29, 1977, petitioner claimed an allowance for depreciation with respect to the Addition, based upon an estimated useful life of 40 years. After the pleadings were filed in the instant case, petitioner filed amended returns claiming one-half of the allowable first year's depreciation with respect to the Addition for the taxable year ended December 30, 1976, and a full year's depreciation for the taxable year ended December 29, 1977. The allowance for depreciation claimed on these amended returns was computed using the 200-percent declining balance method provided for in section 167(b)(2), and an estimated useful life of 8 years.

OPINION

Issue 1. Investment Tax Credit

The first issue is whether petitioner is entitled to an investment tax credit under section 38 with respect to the

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[5] Petitioner also claimed, and respondent disallowed, investment tax credit carrybacks from its taxable year ended Dec. 30, 1976, with respect to $27,710 of costs relating to vestibules constructed in refrigerated facilities other than the Addition. In an amendment to the petition filed herein, petitioner indicated that it would not contest respondent's determination with respect to such costs.

[6] Of this amount, $404,585 represents the segregable cost of the structure that comprises the refrigerated area of the Addition, together with the electrical components allocable to that portion of the Addition. This $404,585 figure excludes the cost of the truck and rail loading platforms, the dock leveling equipment, truck loading pad, electrical components relating to the loading docks, and other costs not directly related to the structure which encloses the refrigerated area of the Addition.

Addition to an extent greater than allowed by respondent. Section 38 allows a credit against tax as determined under sections 46 and 48. Under section 46, there is allowed as a credit a specified percentage of the taxpayer's investment in certain qualifying property, known as section 38 property. See secs. 46(a) and 46(c). The dispute of the parties in the instant case concerns whether the Addition constitutes or consists of section 38 property.

The term "section 38 property" is defined in section 48(a)(1), which provides, in relevant part, as follows:

> (1) IN GENERAL.— * * * the term "section 38 property" means—
>
> (A) tangible personal property, or
>
> (B) other tangible property (not including a building and its structural components) but only if such property—
>
> (i) is used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or
>
> (ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or
>
> (iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state), * * *
>
> Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more.

As the statutory language indicates, sections 48(a)(1)(A) and 48(a)(1)(B) create two distinct categories of section 38 property. First, tangible personal property will be considered section 38 property under section 48(a)(1)(A). Second, other tangible property, other than a building and its structural components, may qualify as section 38 property under section 48(a)(1)(B), but only if it is used as an integral part of, or (in the case of research facilities and bulk storage facilities described respectively in subparagraphs (ii) and (iii) thereof), used in connection with, one of the qualifying activities described in section 48(a)(1)(B)(i). See *Giannini Packing Corp. v. Commissioner*, 83 T.C. 526, 531-532 (1984); *Central Citrus Co. v. Commissioner*, 58 T.C. 365, 370 (1972); *Schuyler Grain Co. v. Commissioner*, 50 T.C. 265, 269 (1968), affd. 411 F.2d 649 (7th Cir. 1969). Petitioner has conceded that the Addition is used neither as an integral part of, nor in connection with, a qualifying activity,[7] and, thus, does not argue that it constitutes other tangible property described in section 48(a)(1)(B). Rather, petitioner asks us to hold that the Addition is tangible personal property qualifying as section 38 property under section 48(a)(1)(A). Thus, the focus of our inquiry is whether the Addition constitutes or consists of tangible personal property within the meaning of section 48(a)(1)(A).[8]

The term "tangible personal property" is defined in section 1.48-1(c), Income Tax Regs. This regulation, which was promulgated under the broad grant of authority contained in section 38(b), provides as follows:

> (c) *Definition of tangible personal property.*—If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal." Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, *the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures).* Thus, buildings, swimming

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[7] As stated in our findings of fact, the Addition is not used either to process or to manufacture frozen foods, and the products stored therein are final-processed, packaged frozen foods.

[8] By virtue of an amendment to the petition filed prior to trial, petitioner alleged that the Addition is tangible personal property under sec. 48(a)(1)(A), and, alternatively, that it is used as an integral part of the manufacturing or production activities of the frozen food processors who store goods therein, and thus qualifies as other tangible property under sec. 48(a)(1)(B)(i). Such amendment withdrew petitioner's allegations, previously raised in the petition, (a) that the Addition is used by food processors to store fungible frozen foods in bulk, and thus constitutes a storage facility described in sec. 48(a)(1)(B)(iii), and (b) that certain components of the Addition, such as vestibule doors, dock levelers and doors, electrical components, and low temperature insulation qualify as tangible personal property under sec. 48(a)(1)(A). Notwithstanding its alternative allegation in the amendment to the petition, petitioner has abandoned its contention that the Addition is other tangible property used in a qualifying activity described in sec. 48(a)(1)(B)(i). In his opening statement, counsel for petitioner distinguished the instant case from certain prior cases of this Court concerning other refrigerated facilities on the ground that such cases involved "either the processing exception for other tangible property or the storage exception for other tangible property [under sec. 48(a)(1)(B)], neither of which we can see as available to us in this case." Similarly, petitioner has not asserted on brief that the Addition is "other tangible property" which qualifies as sec. 38 property under sec. 48(a)(1)(B). Accordingly, petitioner's sole contention is that the Addition qualifies as tangible personal property under sec. 48(a)(1)(A).

> pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. *Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.* [Emphasis supplied.]

Respondent points out that under section 1.48-1(c), Income Tax Regs., the term "tangible personal property" does not include land and improvements thereto, such as buildings or other inherently permanent structures, or structural components of such buildings or structures. In respondent's view, the Addition constitutes a building and is thus excluded from the definition of tangible personal property by the express terms of section 1.48-1(c), Income Tax Regs. Petitioner asserts, however, that the Addition is not a building under applicable judicial interpretations of such term. Further, petitioner contends that the Addition is in essence a giant refrigerator or freezer and is "property which is in the nature of machinery" described in the penultimate sentence of section 1.48-1(c), Income Tax Regs. Petitioner argues that the Addition therefore constitutes tangible personal property. In view of the respective positions of the parties, and in light of the fact that a determination that the Addition is a building would obviate the need for further inquiry herein, we will first address the issue of whether the Addition is a building.

When enacting the investment tax credit provisions as part of the Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960, Congress excluded buildings and their structural components from eligibility for the credit. In doing so, Congress intended that the term "building" be given its "commonly accepted meaning, that is, a structure or edifice enclosing a space within its walls, and usually covered by a roof." H. Rept. 1447, 87th Cong., 2d Sess. A18, 1962-3 C.B. 405, 516;

S. Rept. 1881, 87th Cong., 2d Sess. 154-155, 1962-3 C.B. 707, 858-859. See, e.g., *Yellow Freight System, Inc. v. United States*, 538 F.2d 790, 795-796 (8th Cir. 1976), revg. and remanding 413 F. Supp. 357 (W.D. Mo. 1975); *Samis v. Commissioner*, 76 T.C. 609, 617 (1981); *Valmont Industries, Inc. v. Commissioner*, 73 T.C. 1059, 1072 (1980); *Satrum v. Commissioner*, 62 T.C. 413, 416 (1974). Nevertheless, the term "building," as used in this context, "has caused much consternation among taxpayers and has produced a correspondingly large amount of litigation." *Scott Paper Co. v. Commissioner*, 74 T.C. 137, 177 (1980) (citations omitted). Certain structures which might in common understanding be considered buildings have, in various cases, been held not to be buildings for purposes of the investment tax credit. *Brown & Williamson Tobacco Corp. v. United States*, 369 F. Supp. 1283 (W.D. Ky. 1973), affd. per curiam 491 F.2d 1258 (6th Cir. 1974) (tobacco sheds); *Brown-Forman Distillers Corp. v. United States*, 205 Ct. Cl. 402, 414-416, 499 F.2d 1263, 1270-1271 (1974) (whiskey maturation facilities); *Thirup v. Commissioner*, 508 F.2d 915 (9th Cir. 1974), revg. 59 T.C. 122 (1972) (greenhouses). See generally *Consolidated Freightways v. Commissioner*, 74 T.C. 768, 794 (1980), affd. in part and revd. in part 708 F.2d 1385 (9th Cir. 1983). It is thus accurate to say that, in the investment tax credit context, the term "building" has become a term of art. See *Scott Paper Co. v. Commissioner*, *supra* at 177.[9]

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[9] This fact is not surprising. As this Court noted in *Catron v. Commissioner*, 50 T.C. 306, 310-311 (1968), the statute itself contemplates that certain structures, such as research and storage facilities, may qualify as sec. 38 property under sec. 48(a)(1)(B), even though it is difficult to conceive of many of such facilities "which are not, in some sense, buildings." At least with respect to sec. 48(a)(1)(B), an overly broad application of the term "building" would, in effect, render the remainder of that statutory provision a nullity by categorizing as buildings and denying the credit for many structures to which Congress actually intended the credit to be applicable. Accordingly, courts have been faced with the often delicate task of construing the term "building" so as to give effect to the statute, while yet being mindful of Congress' stated intention that the credit not be extended to "buildings" and their structural components. While the aforementioned considerations might appear more relevant in the context of sec. 48(a)(1)(B) than in that of sec. 48(a)(1)(A), no attempt has been made, either in the decided cases or in respondent's regulations, to define the term "building" differently in the two contexts. See sec. 1.48-1(e)(1), Income Tax Regs. Indeed, to do so would, in our view, inject further complexity into this already difficult area of the tax law. We do note, however, that under sec. 48(a)(1)(A), unlike sec. 48(a)(1)(B), not only buildings, but also other inherently permanent structures, are generally excluded from eligibility for the credit. Compare sec. 1.48-1(c), Income Tax Regs., with sec. 1.48-1(d)(1), Income Tax Regs. See *McKenzie v. Commissioner*, 85 T.C. 875, 896 (1985).

The term "building" is defined in section 1.48-1(e)(1), Income Tax Regs., which provides, in pertinent part, as follows:

> Sec. 1.48-1(e). *Definition of building and structural components.*
>
> (1) Buildings and structural components thereof do not qualify as section 38 property. The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. * * * Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

This regulation has been interpreted to establish a two-part test which considers both "appearance" and "function" in determining whether a particular structure is a "building." Some of the decided cases appear to focus more heavily upon the appearance test which, as its name implies, looks to whether the structure has the appearance of a building in the ordinary sense. See *Yellow Freight System, Inc. v. United States*, 538 F.2d 790, 797-798 (8th Cir. 1976); cf. *A.C. Monk & Co. v. United States*, 686 F.2d 1058 (4th Cir. 1982), affg. in part, revg. and remanding in part an unreported District Court decision. However, most decisions of this Court and other courts have tended to emphasize the functional test. See, e.g., *Thirup v. Commissioner*, 508 F.2d at 919; *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. 443, 456-457, 620 F.2d 862, 870 (1980). *Brown-Forman Distillers Corp. v. United States*, 205 Ct. Cl. 402, 416-418, 499 F.2d 1263, 1270-1272 (1974); *Consolidated Freightways v. Commissioner*, 74 T.C. 768, 793-795 (1980), affd. on this issue 708 F.2d 1385 (9th Cir. 1983); *Scott*

Paper Co. v. Commissioner, supra at 178; *Valmont Industries, Inc. v. Commissioner, supra* at 1072; *Lesher v. Commissioner*, 73 T.C. 340, 363 (1979), affd. per curiam 638 F.2d 64 (8th Cir. 1981); *Satrum v. Commissioner, supra* at 416; *Central Citrus Co. v. Commissioner*, 58 T.C. 365, 371 (1972); *Catron v. Commissioner*, 50 T.C. 306, 310-311 (1968).

The functional test was first expressed by this Court in *Catron v. Commissioner, supra*. Therein, we noted that section 1.48-1(e)(1), Income Tax Regs., defines "building" as a structure providing space for certain enumerated purposes, such as "the furnishing of shelter or housing, or of working, office, parking display or sales space." While noting that the purposes set forth in section 1.48-1(e)(1), Income Tax Regs., are exemplary and not all-inclusive, we nevertheless construed the regulation to limit the scope of the term "building" to structures used for purposes or functions similar to those enumerated therein. *Catron v. Commissioner, supra* at 311. More recently, this Court has described the functional test as one which inquires whether the purpose of the structure at issue is a purpose ejusdem generis to the purposes described by example in section 1.48-1(e)(1), Income Tax Regs., and whether the structure performs a function similar to those structures therein enumerated as buildings, i.e., apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. *Consolidated Freightways v. Commissioner*, 74 T.C. at 795.

In applying the functional test, a major focus of inquiry is whether the structure provides working space for employees which is more than merely incidental to the primary function of the structure. See, e.g., *Brown-Forman Distillers Corp. v. United States*, 205 Ct. Cl. at 418, 499 F.2d at 1271; *Valmont Industries, Inc. v. Commissioner, supra* at 1072; *Scott Paper Co. v. Commissioner, supra* at 178; *Catron v. Commissioner, supra* at 316. In this regard, it is appropriate to consider both the quantity and quality of the human activity within the structure. See *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. at 461, 620 F.2d at 873; *Consolidated Freightways v. Commissioner*, 74 T.C. at 795; *Satrum v. Commissioner, supra* at 417. With the foregoing principles in mind, we now consider whether the Addition constitutes a "building."

It is clear from the testimony of witnesses and photographs in the record that the Addition resembles a building in appearance, and petitioner does not argue to the contrary. Thus, the Addition would be considered a building under the appearance test of section 1.48-1(e)(1), Income Tax Regs. However, the appearance test alone is not determinative; decisions of this Court have emphasized the functional test, and we therefore proceed with our inquiry thereunder.

The Addition consists of three principal areas—the truck loading platform, the rail loading platform, and the refrigerated area. Since these areas are distinct, we think it appropriate to consider each such area separately under the functional test. See, e.g., *Central Citrus Co. v. Commissioner, supra* at 371; and *Catron v. Commissioner, supra* at 313. Cf. *Scott Paper Co. v. Commissioner, supra* at 173-174; *Illinois Cereal Mills, Inc. v. Commissioner*, 789 F.2d 1234 (7th Cir. 1986), affg. a Memorandum Opinion of this Court.[10]

First, we examine the truck loading platform. This area is an enclosed space which comprises approximately 3,900 square feet. In this area, petitioner's employees load and unload refrigerated trucks which transport frozen foods to and from the Addition. Unlike the refrigerated area of the Addition, the truck loading platform is not refrigerated and thus, the employees need not and do not wear protective cold weather gear therein. The platform contains sufficient space for consolidating and storing products so that the frozen foods can be quickly loaded when a common carrier arrives. Petitioner's employees assigned to the Addition spend a substantial part of their workday within the loading platform area.

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[10] In *Catron v. Commissioner*, 50 T.C. 306 (1968), and *Central Citrus Co. v. Commissioner*, 58 T.C. 365 (1972), we looked at discrete areas of a larger structure to determine whether such areas might separately qualify as sec. 38 property. Nevertheless, respondent argues that our consideration of each area of the Addition separately is precluded by *A.C. Monk Co. v. United States*, 686 F.2d 1058 (4th Cir. 1982). In *Monk*, the Fourth Circuit reversed the District Court which, following this Court's decision in *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980), had allowed the investment tax credit for a portion of the taxpayer's electrical system based upon the percentage for which it was used to operate specific machinery. The Fourth Circuit indicated that it saw no basis for making such an allocation and allowing the credit for portions of a "single system." *A.C. Monk & Co. v. United States, supra* at 1065. We consider the instant case to be distinguishable from *Monk* in that the Addition involves physically distinct areas, rather than the "single system" at issue in *Monk*. In any event, this Court has adhered to the approach set forth in *Scotr Paper*, which was recently approved by the Seventh Circuit in *Illinois Cereal Mills, Inc. v. Commissioner*, 789 F.2d 1234 (7th Cir. 1986), affg. a Memorandum Opinion of this Court.

The purpose of the truck loading platform is to facilitate the loading and unloading of frozen food products, and this purpose is accomplished primarily by the efforts of petitioner's employees who work in this area. Human activity is essential, rather than merely incidental, to the function of the platform. Cf. *Consolidated Freightways v. Commissioner*, 74 T.C. at 795-796. In view of the foregoing, we hold that the truck loading platform is a "building" and that the costs relating thereto are thus ineligible for the investment tax credit.

Our conclusion is supported by the case law involving comparable facilities. In *Yellow Freight System, Inc. v. United States, supra*, truck loading docks used by a trucking line to facilitate the movement of freight from inbound to outbound vehicles were found to provide shelter and work space for employees and thus, were held to be "buildings" for purposes of the investment tax credit by the Court of Appeals for the Eighth Circuit. A similar result was reached by the Court of Claims in *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. 443, 620 F.2d 862 (1980), and by this Court in *Consolidated Freightways v. Commissioner*, 74 T.C. 768 (1980), affd. on this issue 708 F.2d 1385 (9th Cir. 1983).[11]

The foregoing considerations require a similar conclusion with regard to the Addition's rail loading platform. While the record contains little information concerning the operation of this platform, we discern no purpose served thereby other than to provide a sheltered area in which petitioner's employees can unload refrigerated boxcars which deliver products to the Addition. Since this area serves to provide working space for petitioner's employees in much the same anner as the truck loading platform, we also conclude that is structure is a building.[12]

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[11] The fact that petitioner's employees use forklifts and pallets to load and unload the trucks on the truck loading platform does not alter our conclusion, since this equipment simply facilitates the task of petitioner's employees—even with this equipment the loading and unloading of products on the truck loading platform is accomplished primarily by the activities of the employees. Cf. *Yellow Freight System, Inc. v. United States*, 538 F.2d 790, 796 (8th Cir. 1976); *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. 443, 459-460, 620 F.2d 862, 871-872 (1980).

Having concluded that the truck and rail loading plat- rms constitute buildings and that the costs relating ereto are ineligible for the investment tax credit, we now nsider the refrigerated area of the Addition.[13] This area mprises approximately 34,650 square feet. It is used to ore prepackaged, final processed frozen foods on behalf of e processors of such foods pending delivery to customers. he temperature therein is maintained between minus five egrees Fahrenheit (-5 degrees F) and zero degrees Fahren- eit (0 degrees F). Due to the low temperature, petitioner's mployees work within this area only to load and unload ozen foods, take inventory, and perform occasional repairs r maintenance. When doing so, they wear cold weather ear, including coveralls, parkas, hats, and gloves. The mployees generally spend no more than 12 minutes at a ime in the refrigerated area.

We think that the principal purpose or function of the efrigerated area is not to furnish working space for petitioner's employees, but rather, to provide an area in which frozen foods may be stored at low temperature. In contrast with the truck and rail loading platforms, the refrigerated area of the Addition is maintained at a temperature which limits, rather than promotes, human activity. Due to the cold temperature, the activities of petitioner's employees are limited in both scope and duration. In the case of the Addition's refrigerated area, the structure itself serves the principal function of low temperature storage of products, and the activities of petitioner's employees are merely supportive of and ancillary to this function. Accordingly, we conclude that the refrigerated portion of the Addition is not a building under the functional test.

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[12] The fact that the rail loading platform was not fully enclosed does not require a contrary conclusion. Cf. *Yellow Freight System, Inc. v. United States*, 223 Ct. Cl. at 456, 620 F.2d at 870 n. 17.

[13] We do not understand petitioner to argue that the truck loading platform and rail loading platform are excluded from the regulations' definition of building as items of "machinery or equipment" under sec. 1.48-1(e)(1)(i), Income Tax Regs. A similar argument was considered, and rejected, in *Yellow Freight System, Inc. v. United States*, *supra* at 796-797; *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. at 463, 670 F.2d at 873-874, and *Consolidated Freightways v. Commissioner*, 74 T.C. at 796-797.

Our conclusion is supported by prior decisions of this Court. In *Catron v. Commissioner, supra*, we held that the refrigerated storage area of a larger quonset-type structure used in the storing, selection, and packaging of apples was eligible for the investment tax credit as a qualifying storage facility under section 48(a)(1)(B)(ii) as then in effect.[14] In so holding, we determined that the refrigerated area was not a building, notwithstanding the entry and exit of employees on forklifts to store and remove goods, which we found to be merely "incidental, subordinate to, and solely in connection with the qualifying apple storage which was the sole use and purpose of the refrigerated facility." *Catron v. Commissioner, supra* at 316.

Catron was followed in *Central Citrus Co. v. Commissioner*, 58 T.C. 365 (1972), and *Merchants Refrigerating Co. of Calif. v. Commissioner*, 60 T.C. 856 (1973). In *Central Citrus*, we held that large, atmospherically controlled "sweet rooms" used in processing citrus fruit were not buildings and further, that they constituted qualifying storage facilities under section 48(a)(1)(B)(ii) as then in effect.[15] In *Merchants Refrigerating*, we held that a large freezer room, which had tilt-up concrete walls and concrete floors and which was used for the storage of frozen foods, was not a building, and that it qualified as a storage facility under section 48(a)(1)(B)(ii) as then in effect.[16] In each of these cases, we determined that the facilities in question were not buildings because they did not furnish working space and human activity therein was limited.[17] In *Merchants Refrigerating* and *Catron*, the placing in storage and removal of goods by employees on forklifts were specifically found not to constitute the type of "work" or human activity necessary to categorize the facility as a building. *Catron v. Commissioner, supra* at 316; *Merchants Refrigerating Co. of Calif. v. Commissioner, supra* at 860.[18] In the instant case, as in the cited cases, the refrigerated area of the Addition does not furnish working space, and human activity therein is limited; petitioner's employees enter and exit the refrigerated area of the Addition only to store or remove goods, take inventory, and perform occasional repairs and maintenance. We think that the refrigerated area of the Addition is not fairly distinguishable from those structures held not to be buildings in *Catron, Central Citrus* and, more particularly, *Merchants Refrigerating*.[19] Thus, following our decisions in those cases, we hold that the refrigerated area of the Addition is not a building.[20]

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[14] See note 20 *infra*.

[15] See note 20 *infra*.

[16] See note 20 *infra*.

[17] Cf. *Giannini Packing Corp. v. Commissioner*, 83 T.C. 526, 531 (1984), in which respondent agreed that large rooms designed and used for the cooling of fruit, and not for human shelter or work space, were not "buildings."

[18] See also *Brown & Williamson Tobacco Corp. v. United States*, 369 F. Supp. 1283 (W.D. Ky. 1973), affd. per curiam 491 F.2d 1258 (6th Cir. 1974). In this regard, we note that, in Rev. Rul. 71-489, 1971-2 C.B. 64, respondent ruled that certain refrigerated structures used in the

In reaching our conclusion that the refrigerated area of the Addition is not a "building," we have considered, and feel compelled to specifically address, respondent's principal arguments to the contrary.

Respondent argues that the refrigerated portion of the Addition serves as a warehouse used in connection with the distribution of frozen food products and must thus be considered a building. Even if we assume that the Addition functions in some measure as a warehouse,[21] we think that,

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processing of milk products and ice cream were sec. 38 property, notwithstanding that employees engaged in stacking and unstacking of products therein.

[19] The refrigerated area of the facility in *Merchants Refrigerating* (273 feet by 133 feet, or 36,309 square feet) is comparable in size to the refrigerated area of the Addition (34,650 square feet).

[20] We recognize that *Catron, Central Citrus*, and *Merchants Refrigerating* were decided under the "storage facility" provision of sec. 48(a)(1)(B)(ii), as in effect prior to the amendment of that section by sec. 104(a)(1) of the Revenue Act of 1971, Pub. L. 92-178, 85 Stat. 497. Such amendment narrowed the class of storage facilities eligible for the credit by deleting the general reference to "storage facility" in clause (ii) of sec. 48(a)(1)(B) and adding to sec. 48(a)(1)(B) a new, more specific clause (iii) referring to a "facility used for the bulk storage of fungible commodities." Nevertheless, under the flush language of sec. 48(a)(1)(B) as in effect both before and after such amendment, a structure would be not eligible for the credit if it were a "building." Thus, in reaching our conclusions in *Catron, Central Citrus*, and *Merchants Refrigerating* that the facilities in issue therein constituted sec. 38 property, we were required to determine both that the facilities did not constitute buildings *and* that such facilities did constitute qualifying storage facilities. See, e.g., *Central Citrus Co. v. Commissioner, supra* at 370, wherein we stated: "Before considering petitioner's assertions [that the facility is qualifying storage facility] we must first examine whether the processing chambers are in fact buildings." *Catron, Central Citrus*, and *Merchants Refrigerating* thus remain viable with respect to the "building" issue decided therein. See *Valmont Industries, Inc. v. Commissioner*, 73 T.C. 1059, 1072 (1980); *Lesher v. Commissioner*, 73 T.C. 340, 363 n. 8 (1979), affd. per curiam 638 F.2d 64 (8th Cir. 1981). To this extent, we apply and follow them here.

[21] In Rev. Rul. 74-452, 1974-2 C.B. 11, respondent has indicated that warehouses are generally "conventional buildings used for general storage purposes." Although respondent concluded therein that certain refrigerated structures used for storing frozen foods were warehouses and not sec. 38 property, we do not think that a facility such as the Addition is a "conventional building used for general storage purposes." First, the Addition is not a conventional building, since it contains numerous construction features which would not be found in a conventional or "dry" warehouse. Second, the Addition is not, in our view, used for

under the cited decisions, it is not on this account to be considered a building, notwithstanding the provisions of section 1.48-1(e)(1), Income Tax Regs. Indeed, in *Merchants Refrigerating*, following our decisions in *Catron* and *Central Citrus*, we explicitly rejected respondent's contention that a similar refrigerated structure there in issue was a building, even though it was acknowledged to be "plainly a type of warehouse." *Merchants Refrigerating Co. of Calif. v. Commissioner, supra* at 859. We adhere to the position expressed in our prior decisions and thus, reject respondent's argument.[22]

Respondent also argues that the Addition, of which the refrigerated area constitutes the largest part, must be considered a building because, in his view, the structure is "reasonably adaptable" to other uses. We similarly reject this argument.

As a preliminary matter, it is not clear that the Addition's adaptability to alternate uses is relevant in the instant case in determining whether it is a building. In nearly all the decided cases in this area, any inquiry concerning adaptability has been made only in specific statutory or regulatory contexts not here in issue. Adaptability has been considered, for example, in determining whether a structure is a qualifying storage facility under section 48(a)(1)(B), or a structure which houses other qualifying property as described in section 1.48-1(e)(1)(ii), Income Tax Regs., or a qualifying single purpose agricultural or horticultural structure under section 48(a)(1)(D).[23] However,

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"general storage purposes," but rather, is both designed and used for the much more specific purpose of storing frozen foods at low temperatures. Thus, notwithstanding respondent's contrary conclusion in Rev. Rul. 74-452, we do not think that a structure like the Addition can fairly be considered a "warehouse" as that term has been used by respondent in the cited ruling.

[22] Notwithstanding our holdings in *Catron*, *Central Citrus*, and *Merchants Refrigerating*, respondent contends that we must conclude that the refrigerated area of the Addition is a building by reason of our holding in *Circle K Corp. v. Commissioner*, T.C. Memo. 1982-298. Respondent's reliance upon that case is misplaced. Therein, the relevant issue was whether a cold storage room, which was part of an ice manufacturing facility, was sec. 38 property under sec. 48(a)(1)(B)(i). We held that the cold storage room was not sec. 38 property, not on the grounds that it was a building, but rather, because the taxpayer had failed to show the facility was used as an integral part of a qualifying activity as required by sec. 48(a)(1)(B)(i). *Circle K Corp. v. Commissioner, supra*, thus does not require a conclusion contrary to that reached by us herein.

[23] Adaptability has been considered relevant where a structure is claimed to be a qualifying storage facility under sec. 48(a)(1)(B). See, e.g., *Catron v. Commissioner, supra* at 315, citing with approval Rev. Rul. 66-89, 1966-1 C.B. 7, 8-9, which prescribes an inquiry into adaptability

most of the cases which have considered whether a structure is a building have done so by applying the appearance and functional tests, either without considering adaptability, or doing so only where one of the above-cited statutory or regulatory provisions was also at issue.[24]

Furthermore, even if we considered adaptability to be a relevant factor in this context, we would still reject respondent's position, since we think that the Addition is not reasonably adaptable to uses other than low temperature storage. Respondent contends that if the refrigeration system were simply switched off, the Addition could be economically used as a dry warehouse. However, petitioner provided credible testimony, supported by pro forma financial statements, to show that the Gateway Facility, of which the Addition was a part, could be operated profitably as a refrigerated facility, but would operate at a substantial loss if used as a dry warehouse. We find this evidence to be convincing. At trial, respondent introduced an expert wit-

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in the storage facility context. See also, e.g., *Tamura v. United States*, 734 F.2d 470 (9th Cir. 1984), revg. and remanding an unreported District Court order; *Brown & Williamson Tobacco Corp. v. United States*, 369 F. Supp. 1283 (W.D. Ky. 1973), affd. per curiam 491 F.2d 1258 (6th Cir. 1974); *Lesher v. Commissioner, supra* at 364; *Central Citrus Co. v. Commissioner, supra* at 371-372; *Olson v. Commissioner*, T.C. Memo. 1970-296. See also Rev. Rul. 84-60, 1984-1 C.B. 13.

Similarly, adaptability has been considered in determining whether a structure is essentially a "skin covering" which houses other qualifying property so as to be within a specific exception to the definition of "building" under sec. 1.48-1(e)(1)(ii), Income Tax Regs. The cited regulation indicates that, in determining whether the exception is applicable, a factor to be considered is "whether the structure could be economically used for other purposes." See, e.g., *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. 443, 463, 620 F.2d 862, 873-874 (1980); *Stuppy, Inc. v. United States*, 454 F. Supp. 1378, 1384-1385 (W.D. Mo. 1978); *Endres Floral Co. v. United States*, 450 F. Supp. 16, 24-26 (N.D. Ohio 1977); *Valmont Industries, Inc. v. Commissioner, supra* at 1075-1078; *Satrum v. Commissioner, supra* at 416-417. See also *Illinois Cereal Mills, Inc. v. Commissioner*, T.C. Memo. 1983-469, affd. 789 F.2d 1234 (7th Cir. 1986); *Schenk v. Commissioner*, T.C. Memo. 1980-531.

Lastly, adaptability has also been considered in determining whether a structure is a single-purpose agricultural or horticultural structure. Such a structure may qualify as sec. 38 property under sec. 48(a)(1)(D) if it is specifically designed, constructed, and used for specified purposes. See sec. 48(p). Under sec. 1.48-10(d), Income Tax Regs., a structure is "specifically designed and constructed if it is not economic to design and construct the structure for the intended qualifying purpose and then use the structure for a different purpose." This Court has construed this regulation to prescribe an inquiry into a structure's adaptability in determining its qualification under sec. 48(a)(1)(D). See *McKenzie v. Commissioner*, 85 T.C. 875, 897-898 (1985).

[24] See, e.g., *Yellow Freight System, Inc. v. United States*, *supra*; *Thirup v. Commissioner*, 508 F.2d 915 (9th Cir. 1974), revg. 59 T.C 122 (1972); *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. 443, 620 F.2d 862 (1980); *Brown-Forman Distillers Corp. v. United States*, 205 Ct. Cl. 402, 499 F.2d 1263 (1974); *Consolidated Freightways v. Commissioner*, 74 T.C. 768 (1980), affd. in part and revd. in part 708 F.2d 1385 (9th Cir. 1983). But see *A.C. Monk & Co. v. United States*, 686 F.2d 1058 (4th Cir. 1982).

ness who opined that the Addition is "economically adaptable" to various uses, including a dry warehouse, a trucking terminal, or an indoor racquetball or tennis facility. However, such witness offered no support for this conclusion, and we discern none in the record.[25] Thus, based upon the record before us, we do not think that the refrigerated area of the Addition is economically adaptable to uses other than refrigerated storage.

Having concluded that the refrigerated area of the Addition is not a "building,"[26] we turn now to the issue of whether the refrigerated area is, as petitioner contends, "tangible personal property" under section 48(a)(1)(A), and is thus eligible for the investment tax credit in an amount greater than allowed by respondent. As indicated in our findings of fact, respondent has allowed the credit for certain refrigeration system components of the Addition, including refrigeration pipes and pipe insulation, valves, and motors, having a cost of $103,470.12. Thus, the remaining costs for which petitioner is seeking the investment tax credit relate, in essence, to the structural elements of the refrigerated area of the Addition, including its foundation footings, walls, floor, roofing and supports, vapor barrier, insulation, and electrical components allocable thereto, having a cost of $404,585.[27] Petitioner bears the burden of proving its entitlement to the claimed credit. See *Uecker v.*

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[25] We think that the uses suggested by respondent's expert are indeed theoretically possible but, in view of the fact that the Addition involves numerous special construction features and was constructed at substantial cost to provide a specialized structure in which low temperatures could be maintained, such alternative applications do not represent economically reasonable uses of the facility. Cf. *Stuppy, Inc. v. United States, supra* at 1384, where, in the context of the "skin covering" exception of sec. 1.48-1(e)(1)(iii), Income Tax Regs., described above, the Court found that the greenhouses there in issue "could *theoretically* be used for a multitude of alternative uses, but *economically* and *practically* speaking," could not be so used.

Cf. also Rev. Rul. 84-60, 1984-1 C.B. 13, wherein respondent indicates that, in determining the adaptability of a storage facility, not only the cost of conversion, but also, the *feasibility* of alternative use must be considered. Cf. also *Catron v. Commissioner, supra* at 315, and *Central Citrus Co. v. Commissioner, supra* at 371-372, in which we held that the cold temperatures in the facilities there in issue limited their reasonable adaptability.

[26] Since we have held that the refrigerated portion of the Addition is not a "building" under applicable case law, we need not and do not consider whether it satisfies the exception to the definition of that term contained in sec. 1.48-1(e)(1)(i), Income Tax Regs., as a "structure which is essentially an item of machinery or equipment." Compare, e.g., *Yellow Freight System, Inc. v. United States, supra* at 796-797; *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. at 463, 620 F.2d at 873-874; *Endres Floral Co. v. United States, supra* at 24; *McKenzie v. Commissioner, supra* at 896; *Consolidated Freightways v. Commissioner*, 74 T.C. at 796-797.

[27] See note 6 *supra*.

Commissioner, 81 T.C. 983, 998 (1983), affd. per curiam on another issue 766 F.2d 909 (5th Cir. 1985); *Evans v. Commissioner*, 48 T.C. 704, 709 (1967), affd. per curiam 413 F.2d 1047 (9th Cir. 1969); Rule 142(a), Tax Court Rules of Practice and Procedure.

Section 48(a)(1)(A), unlike section 48(a)(1)(B), generally excludes from its scope not only buildings, but also other inherently permanent structures and their structural components. Compare sec. 1.48-1(c), Income Tax Regs., with sec. 1.48-1(d)(1), Income Tax Regs. See *McKenzie v. Commissioner*, 85 T.C. 875, 896 (1985). The record does not indicate that the refrigerated area of the Addition is anything but an inherently permanent structure, and petitioner does not argue otherwise. See generally *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, 672-673 (1975). See also *McKenzie v. Commissioner*, *supra* at 895-897.[28] Accordingly, other than as allowed by respondent, the costs relating to the refrigerated area of the Addition would appear to be ineligible for the investment tax credit by reason of the general rule of section 1.48-1(c), Income Tac Regs., which provides that inherently permanent structures will not qualify as tangible personal property for purposes of section 48(a)(1)(A). However, petitioner relies upon section 1.48-1(c), Income Tax Regs., the penultimate sentence of which provides that, "all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building." Petitioner argues that, under this provision, property which is in the nature of machinery may qualify as tangible personal property even if it is inherently permanent. Petitioner asserts that the structural elements of th refrigerated area of the Addition operate together with th refrigeration system to make the refrigerated area functio like a giant refrigerator or freezer and contends that th refrigerated area is thus property in the nature of machinery. Petitioner therefore concludes that all the component of the refrigerated area, including the structural elements are eligible for the investment tax credit as tangibl personal property. Respondent acknowledges that, unde section 1.48-1(c), Income Tax Regs., property which is in th nature of machinery may qualify as tangible persona property even if it is inherently permanent.[29] However respondent disagrees with petitioner's characterization o the refrigerated area as property in the nature of machiner and, accordingly, disputes the applicability of the cite provision of section 1.48-1(c), Income Tax Regs.

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[28] In *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, 672-673 (1975), we set forth the following six basic inquiries considered relevant in determining whether a structure is an inherently permanent structure:

(1) Is the property capable of being moved and has it in fact been moved?

(2) Is the property designed or constructed to remain permanently in place?

(3) Are there circumstances which tend to show the expected or intended length of affixation, i.e., are there circumstances which show that the property may or will have to be moved?

(4) How substantial a job is removal of the property and how time consuming is it?

(5) How much damage will the property sustain upon its removal?

(6) What is the manner of affixation of the property to the land?

The Addition is affixed to the land by means of a concrete foundation, placed at a depth of 2 to 3 feet. It is designed to remain indefinitely in its present site. The insulation and vapor barrier as well as the underfloor ventilation system cannot be removed without causing damage to the structure. We think that the structure of the refrigerated area of the Addition must be considered inherently permanent under the factors listed above.

We think that petitioner's position evidences considerabl ingenuity. Nevertheless, after serious reflection, we ar persuaded for the reasons which follow that it must b rejected.[30]

Petitioner's reliance upon section 1.48-1(c), Income Ta Regs., is based largely upon *Weirick v. Commissioner*, 6 T.C. 446 (1974), a previous decision of this Court t construe that portion of the cited regulation relating t property "in the nature of machinery."[31] Petitioner contends that, under the rationale of *Weirick*, the refrigerated area of the Addition must be considered to be property in the nature of machinery within the meaning of section 1.48-1(c), Income Tax Regs. However, we do not consider our decision in *Weirick* to require a holding for petitioner herein.

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[29] In *Roberts v. Commissioner*, 60 T.C. 861 (1973), respondent had taken the position th sec. 1.48-1(c), Income Tax Regs., excludes from the definition of tangible personal property s structures which are "inherently permanent," even if they are "in the nature of machinery. However, in *Weirick v. Commissioner*, 62 T.C. 446 (1974), respondent subsequently abandone this position and conceded that property in the nature of machinery may qualify as tangibl personal property even if it is inherently permanent. See *Weirick v. Commissioner*, *supra* 452-453. Respondent's position in the instant case is consistent with that taken by him *Weirick v. Commissioner*, *supra*.

[30] On brief, petitioner appears to also suggest that the refrigerated area of the Addition mu be considered to be tangible personal property, because it is, in petitioner's view, similar function to an ordinary kitchen refrigerator which itself would be considered tangible person property under sec. 48(a)(1)(A). A similar argument was previously raised, but not considere in *Merchants Refrigerating Co. of California v. United States*, 659 F.2d 116 (9th Cir. 1981 Therein, the Court of Appeals for the Ninth Circuit affirmed the District Court's holding th a certain refrigerated facility was not other tangible property described in sec. 48(a)(1)(B)(because it was not used in the bulk storage of fungible commodities, and refused to consid the argument, raised for the first time on appeal, that the facility was, in essence, a "gia refrigerator" qualifying as sec. 38 property under sec. 48(a)(1)(A). See *Merchants Refrigerati Co. of California v. United States*, *supra* at 117. We reject such an argument, insofar as pertains to the refrigerated area of the Addition because it ignores the fact that th refrigerated area is, unlike an ordinary kitchen refrigerator, an inherently permanent structur and, as such, is generally excluded from the definition of tangible personal property under se 48(a)(1)(A). See sec. 1.48-1(c), Income Tax Regs.

In *Weirick*, the issue before the Court was whether certain cable support and holddown towers ("line towers") and certain ramps used in the operation of a ski lift were section 38 property. The line towers were placed at various points along the course of the ski lift and served to either support or hold down the lift cable. The ramps were placed at each end of the lift and were either easily moveable wooden platforms or earthen platforms of dirt which had been bulldozed or hauled into place.

We found that the line towers were so affixed to the ground as to be considered "inherently permanent structures." We noted, however, that attached to the towers were sheave assemblies, consisting of four to eight rubber-tired pulleys upon which the lift cable would travel. The line towers had no function other than to support these sheave assemblies, which themselves were concededly property in the nature of machinery. The towers and the sheave assemblies were physically connected, and when replacement was necessary, it was often as economical to replace the tower and its related sheave assembly as to simply replace the sheave assembly on an existing tower. Upon these facts, we determined that the line towers and the sheave assemblies were so closely related that they could not properly be considered two separate groups of assets but rather, formed an inseparable, integral mechanism which was property in the nature of machinery within th meaning of section 1.48-1(c), Income Tax Regs. Accordingly we held that costs relating to the line towers were eligibl for the investment tax credit.

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[31] We emphasize that at issue herein is the applicability of that provision of sec. 1.48-1(c), Income Tax Regs., which defines the term "tangible personal property" to include "property which is in the nature of machinery." This regulation is to be distinguished from sec. 1.48-1(e)(1)(i), Income Tax Regs., which excludes from the definition of the term "building," property which is "essentially an item of machinery or equipment." See note 25 *supra*. The language of sec. 1.48-1(e)(1)(i), Income Tax Regs., is broader than that of sec. 1.48-1(c), Income Tax Regs., since it encompasses not only "machinery," but "equipment" as well. Therefore, the fact that property would be considered an "item of machinery or equipment" within sec. 1.48-1(e)(1)(i), Income Tax Regs., does not mean that it must also be considered to be "property which is in the nature of machinery" within sec. 1.48-1(c), Income Tax Regs. Thus, although respondent ruled in Rev. Rul. 71-489, 1971-2 C.B. 64, that certain refrigerated structures were "essentially items of machinery or equipment" so as to be excluded from the definition of building within the provisions of sec. 1.48-1(e)(1)(i), Income Tax Regs., that ruling does not compel the conclusion that the refrigerated area of the Addition is "property in the nature of machinery" within sec. 1.48-1(c), Income Tax Regs.

With regard to the ramps at issue in *Weirick*, we foun that the wooden ramps qualified as tangible persona property because they were easily moveable, but that th earthen ramps were improvements to land and as such were excluded from the definition of tangible persona property under section 1.48-1(c), Income Tax Regs.

It is significant to note that, in *Weirick*, our inquiry wa focused upon the specific items of property in issue, i.e., th ramps and the line towers. We specifically declined to adop the view that the entire ski lift constituted property in th nature of machinery and to therefore hold that all relate components were, as such, tangible personal property unde section 1.48-1(c), Income Tax Regs. *Weirick v. Commissioner, supra* at 455. Thus, we refused to hold that th wooden and earthen ramps were property in the nature o machinery merely because they were used in connectio with the lift. Similarly, we did not hold the line towers to b property in the nature of machinery merely because the were part of the ski lift. Rather, our holding with respect t such towers was based upon their close relationship to th sheave assemblies which, themselves, were property in th nature of machinery.

We believe that in applying the rationale of *Weirick v Commissioner, supra*, to the facts of the instant case, ou inquiry must focus, not upon the refrigerated area of th Addition as a whole, but rather, upon the structura elements thereof for which petitioner is seeking an investment tax credit. After considering the record, we do no think that the structural elements of the refrigerated are of the Addition can be said to be property in the nature o machinery. First, the structural elements are fixed in plac and do not themselves serve a "machinery" type functio Moreover, unlike the line towers at issue in *Weirick*, th structural elements are not so closely related to othe property as to be considered property in the nature o machinery. To be sure, the structural elements work in conjunction with the refrigeration system components, which are concededly "property in the nature of machinery," to provide an enclosed, refrigerated space. Nevertheless, unlike the line towers and sheave assemblies in *Weirick*, we do not find the structural elements to be so closely associated with the refrigeration system as to comprise an integral, single asset. There is, for example, no showing herein, as there was with regard to the line towers and sheave assemblies in *Weirick*, that, when necessary, it would be as economical to replace both the structural elements and the refrigeration system components as it would be to simply replace the refrigeration system components themselves. Indeed, it appears from the record that the refrigeration system components may be replaced without replacing the structural elements. Moreover, in contrast with the line towers in *Weirick*, the purpose of the structural elements herein is not simply to support and assist the functioning of other property which is in the nature of machinery. Here, the refrigeration system can operate independently of the structural elements, and the structural elements themselves serve a function independent of the refrigeration system—that of keeping out humidity and reducing temperature migration, and providing an enclosed, protected space in which frozen foods may be stored. Thus, we do not think that the structural elements can be said to be so closely related to the refrigeration system as to be considered therewith a single asset which is in the nature of machinery under the rationale of *Weirick v. Commissioner, supra.*[32]

Moreover, even if we were to go beyond the approach taken in *Weirick v. Commissioner, supra*, by considering the refrigerated area of the Addition as a whole, our conclusion would be the same. The refrigerated area is a fixed, stationary structure. Its primary function is to store frozen foods at low temperatures. Although it contains, and functions with the aid of, refrigeration system components which are in the nature of machinery, we do not think that the structure's primary function may be thought of as mechanical or accomplished by "machinery" in the ordinary sense of that term.[33] Thus, we do not think that, considered as a whole, the refrigerated area of the Addition may fairly be characterized as property in the nature of machinery within the meaning of section 1.48-1(c), Income Tax Regs.

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[32] On brief, petitioner also relies upon *Marineland of the Pacific, Inc. v. Commissioner*, T.C. Memo 1975-288. In that case, we found steel towers which were part of a gondola ride used by an amusement park to be analogous to the line towers at issue in *Weirick v. Commissioner, supra.* Following our decision in *Weirick*, we thus held such towers to be property in the nature of machinery under sec. 1.48-1(c), Income Tax Regs. Since our decision in *Marineland* was based upon our holding in *Weirick v. Commissioner, supra*, and we have found that *Weirick* does not require a holding for petitioner in the instant case, we similarly do not view *Marineland of the Pacific, Inc. v. Commissioner, supra*, to require a holding for petitioner.

Our conclusion that the refrigerated area is not "tangible personal property" under section 1.48-1(c), Income Tax Regs., and section 48(a)(1)(A) finds support in, and is consistent with, the statutory structure of sections 48(a)(1)(A) and 48(a)(1)(B) and the distinction created therein between "tangible personal property" and "other tangible property." Under section 48(a)(1)(A), "tangible personal property" will be eligible for the investment tax credit, irrespective of whether it is used as an integral part of, or in connection with, a qualifying activity described in section 48(a)(1)(B)(i). See sec. 48(a)(1)(A); sec. 1.48-1(c), Income Tax Regs. Under section 48(a)(1)(B), however, "other tangible property" will qualify for the credit only if it is used as an integral part of, or in connection with, a qualifying activity. See sec. 48(a)(1)(B); sec. 1.48-1(d)(1), Income Tax Regs. It is thus clear that, by requiring that "other tangible property" be used as an integral part of, or in connection with, a qualifying activity under section 48(a)(1)(B), Congress intended to impose additional conditions where the credit is claimed for such property. We think that a large, inherently permanent structure such as the refrigerated area of the Addition, which has a concrete foundation, tilt-up concrete walls and a roof, and which comprises approximately 34,650 square feet, is more appropriately categorized, not as "tangible personal property" but rather, as "other tangible property" and, as such, must meet the requirements of section 48(a)(1)(B) in order to be eligible for the investment tax credit.[34] Petitioner has conceded that the requirements of section 48(a)(1)(B) have not been satisfied, because the refrigerated area of the Addition is not used as an integral part of, or in connection with, a qualifying activity. Nevertheless, petitioner asks us to, in effect, ignore these requirements by classifying the refrigerated area of the Addition as "tangible personal property." We believe that to do so would not only give an impermissibly broad meaning to the term "tangible personal property" but would also frustrate the statutory design of Congress, which requires that "other tangible property" be used as an integral part of or in connection with a qualifying activity in order to be eligible for the investment tax credit. We are, therefore, unwilling to construe the language of section 1.48-1(c), Income Tax Regs., pertaining to "property which is in the nature of machinery" so broadly as to bring the refrigerated area of the Addition within the category of "tangible personal property" under section 48(a)(1)(A).[35]

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[33] Cf. *Yellow Freight System, Inc. v. United States*, *supra* at 796-797; *Consolidated Freightways, Inc. v. United States*, 223 Ct. Cl. at 463, 620 F.2d at 873-874 (1980); *Endres Floral Co. v. United States*, *supra* at 24; *McKenzie v. Commissioner*, *supra* at 896; *Consolidated Freightways v. Commissioner*, 74 T.C. at 796-797.

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[34] Comparable refrigerated facilities have been held to qualify for the investment tax credit, if at all, only as "other tangible property" under sec. 48(a)(1)(B), rather than as "tangible personal property" under sec. 48(a)(1)(A). See e.g., *Merchants Refrigerating Co. of Calif. v. Commissioner*, 60 T.C. 856 (1973). Cf. *Merchants Refrigerating Co. of Calif. v. United States*, 659 F.2d 116 (9th Cir. 1981); *Giannini Packing Corp. v. Commissioner*, 83 T.C. 526 (1984); *Central Citrus Co. v. Commissioner*, 58 T.C. 365 (1972); *Catron v. Commissioner*, 50 T.C. 306 (1968).

We think that the drafting of secs. 48(a)(1)(A) and 48(a)(1)(B) indicates that the classifications of property set forth therein are mutually exclusive. Sec. 48(a)(1)(A) refers to "tangible personal property," and sec. 48(a)(1)(B) refers in turn to "*other* tangible property." (Emphasis supplied.) The use of the word "other" in sec. 48(a)(1)(B) indicates that the term "other tangible property" as used therein must be construed to mean tangible property which is something *other than* tangible personal property or, in other words, tangible property which is not tangible personal property described in sec. 48(a)(1)(A). Thus, a determination that particular property is "other tangible property" under sec. 48(a)(1)(B) would appear to also involve as a corollary the determination that such property is not "tangible personal property" under sec. 48(a)(1)(A). Thus, the fact that comparable facilities were held to be "other tangible property" under sec. 48(a)(1)(B) supports not only the inference that the refrigerated area *is* other tangible property as such term is used in sec. 48(a)(1)(B), but also the inference that it *is not* tangible personal property as such term is used in sec. 48(a)(1)(A).

[35] In closing our consideration of this issue, we note that the language of sec. 1.48-1(c), Income Tax Regs., relied upon by petitioner, provides in relevant part, that "all property which is in the nature of machinery (*other than structural components of a building or other inherently permanent structure*) shall be considered tangible personal property even though located outside a building." (Emphasis supplied.) The parenthetical language of this sentence may be interpreted to preclude both structural components of a building and structural components of an inherently permanent structure from being classified thereunder as tangible personal property. See *Weirick v. Commissioner*, *supra* at 452 n. 7. Given our disposition of this issue, we need not and do not consider the issue, not raised by the parties, of whether the structural elements of the refrigerated area are structural components of an inherently permanent structure within such parenthetical language and are, as such, excluded from the operation of this provision of sec. 1.48-1(c), Income Tax Regs.

For the foregoing reasons, we reject petitioner's contention that the refrigerated area of the Addition is tangible personal property under section 48(a)(1)(A) and section 1.48-1(c), Income Tax Regs. Accordingly, we hold that petitioner is not entitled to an investment tax credit with respect to the Addition to an extent greater than allowed by respondent.

Issue 2. Depreciation

The second and final issue is whether petitioner is entitled to depreciate the Addition using the 200-percent declining balance method under section 167(b)(2) and an 8-year useful life. Resolution of this issue is dependent upon our holding with respect to the investment tax credit issue, and the parties so recognize. See generally *Samis v. Commissioner, supra* at 621.

Section 167(b)(2) generally permits property used in a trade or business or held for the production of income to be depreciated under the declining balance method, with the allowable depreciation not to exceed 200 percent of the amount that would have been allowed if the straight line method had been used. However, under section 167(j)(1)(B), the depreciation allowance under the declining balance method is generally limited to 150 percent of the allowable straight line amount if the property in question is section 1250 property. Thus, petitioner may not use the 200-percent declining balance method of depreciation if the Addition is section 1250 property.

Section 1250 property is defined in section 1250(c) as any depreciable real property other than section 1245 property. Section 1245 property is, in turn, defined in section 1245(a)(3) using terms similar to those used in section 48(a)(1) to define section 38 property. Section 1245(a)(3) provides, in relevant part, that section 1245 property is depreciable property which is either—

> (A) personal property, [or]
>
> (B) other property (not including a building or its structural components) * * * which * * *
>
> (i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

> (ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or
>
> (iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities * * *

Petitioner contends that the Addition is "personal property" under section 1245(a)(3)(A).[36] Insofar as pertinent herein, the term "personal property" as used in section 1245(a)(3)(A) is defined in section 1.1245-3(b)(1), Income Tax Regs., to mean "tangible personal property" as defined in section 1.48-1(c), Income Tax Regs. As we have held in resolving the investment tax credit issue, neither the truck loading platform, nor the rail loading platform, nor the refrigerated area of the Addition qualifies as tangible personal property under section 1.48-1(c), Income Tax Regs. Since the Addition is not tangible personal property under section 1.48-1(c), Income Tax Regs., and section 48(a)(1)(A), it is also not personal property under section 1.1245-3(b)(1), Income Tax Regs., and section 1245(a)(3)(A). It is, therefore, not section 1245 property, but rather, section 1250 property under section 1250(c). Thus, the provisions of section 167(j)(1)(B) are applicable and, thereunder, allowable depreciation of the Addition under the declining balance method is limited to 150 percent of the amount allowable under the straight line method of depreciation. Accordingly, petitioner may not depreciate the Addition using the 200-percent declining balance method of section 167(b)(2).

The 8-year useful life used by petitioner to depreciate the Addition was determined under the Class Life Asset Depreciation Range System, which prescribes certain useful life ranges for various classes of depreciable property. See sec. 167(m), sec. 1.167(a)-11; Income Tax Regs. See also Rev. Proc. 72-10, 1972-1 C.B. 721.[37] Under this system, an 8-year useful life may be used in depreciating certain specified property. However, that period may not be used by petitioner unless the Addition is tangible personal property, and petitioner acknowledges as much. Since we have held that the Addition is not tangible personal property, we also hold that petitioner may not depreciate the Addition using an 8-year useful life.[38]

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[36] Petitioner does not contend that the Addition is described in sec. 1245(a)(3)(B), the relevant language of which is nearly identical to that used in sec. 48(a)(1)(B). Under both sections, "other tangible property" must be used or have been used either as an integral part of, or in connection with, a qualifying activity. As noted in our discussion of the investment tax credit issue, petitioner has conceded that the Addition is used neither as an integral part of nor in connection with a qualifying activity. See notes 7 & 8 and accompanying text *supra*. We consider this concession in the context of sec. 48(a)(1)(B) tantamount to a similar concession in the context of sec. 1245(a)(3)(B).

[37] Rev. Proc. 72-10, 1972-1 C.B. 721, which was applicable during the year in which the Addition was placed in service, was superseded by Rev. Proc. 77-10, 1977-1 C.B. 548, for

To reflect concessions and the foregoing,

Decision will be entered under Rule 155.

HALEY BROTHERS CONSTRUCTION CORP., ESTATE OF JOHN W. HALEY, JOHN W. HALEY, JR., AND JOSEPH A. HALEY, EXECUTORS, AND MARY A. HALEY, ESTATE OF FRANCIS J. HALEY, BONNIE J. HALEY, EXECUTRIX, AND BONNIE J. HALEY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8585-81. Filed August 18, 1986.

On June 18, 1977, petitioner HBC, then a subchapter S corporation, acquired all the stock of an existing corporation (M) that was actively engaged in the business of developing and selling residential real estate lots from a subdivision it owned. Because M was indebted to HBC and was experiencing financial difficulties, HBC decided to acquire M's stock and to complete the real estate development itself. HBC proceeded to clear up M's outstanding debts and, in many respects, operated M as if it were a division of itself. HBC formally dissolved M on May 10, 1979. *Held*: HBC's subchapter S corporation status was terminated in 1977 because it had become a member of an affiliated group contrary to sec. 1371(a), I.R.C. 1954. Thus, HBC could no longer pass through its undistributed income, deductions, and investment credit to its shareholders, the petitioner-husbands.

Benjamin G. Cox and *B. Guille Cox, Jr.*, for the petitioners.

Rodney J. Bartlett, for the respondent.

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property placed in service in taxable years ending on or after Mar. 21, 1977. See Rev. Proc. 77-10, sec. 1.02 and sec. 4.

[38] In closing our opinion, we commend counsel for both parties for their excellent presentation of this case at trial and for their insightful and thoughtful briefs.

CHABOT, *Judge*: Respondent determined a deficiency in Federal corporate income tax against Haley Bros. Construction Corp. for 1977 in the amount of $43,942.43. Respondent determined deficiencies in Federal individual income tax against John W. Haley and Mary A. Haley, and against Francis J. Haley and Bonnie J. Haley, for 1977 in the amounts of $5,617 and $1,962, respectively. After concessions by petitioners, the issue for decision is whether Haley Bros. Construction Corp.'s status as a subchapter S corporation under section 1371[1] terminated in 1977 when it acquired 100 percent of the stock of Marywood Corp. because Haley Bros. Construction Corp. became a member of an affiliated group.[2]

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, Haley Bros. Construction Corp.'s (hereinafter sometimes referred to as HBC) principal place of business was located in Terre Haute, Indiana, and John and Mary Haley (husband and wife) and Francis and Bonnie Haley (husband and wife) resided in Terre Haute. After the petition was filed in the instant case, petitioners John Haley (hereinafter sometimes referred to as John) and Francis Haley (hereinafter sometimes referred to as Francis) died in February 1984, and in October 1982, respectively, and their estates were substituted as petitioners. John and Francis were brothers.

HBC was incorporated under Indiana law in 1956. During 1977, HBC was involved in the construction industry primarily with respect to heavy construction such as building bridges, grading railroad track beds, constructing large sewer lines, and erecting large shovels at coal mine sites. John, in addition to being one of the founders of HBC, was also its chairman and president. He conducted HBC's business as if it were his own business; that is, he made all the major decisions and told the board of directors the actions he intended to take. The board never refused to approve his actions.

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[1] Unless indicated otherwise, all section references are to sections of the Internal Revenue Code of 1954 as in effect for the year in issue.

[2] With the exception of one income adjustment which John and Mary Haley conceded, if Haley Bros. Construction Corp.'s subchapter S corporation status was not terminated in 1977, then deficiencies determined against all petitioners will be eliminated.

From 1966 through 1976, HBC filed its income tax returns as a subchapter S corporation, pursuant to an election made under section 1371.[3] John and Francis, as the only shareholders, filed their income tax returns and paid their Federal income taxes therewith based on HBC's status as a subchapter S corporation.[4] Neither HBC nor its shareholders elected to terminate HBC's subchapter S corporation status for 1977. Petitioners timely filed their respective income tax returns for 1977 in accordance with their belief that HBC was a subchapter S corporation for 1977.

Marywood Corp. (hereinafter sometimes referred to as Marywood) was incorporated under Indiana law on February 7, 1962. In conformance with its organizational purpose, Marywood was involved in selling and developing real estate, including developing a tract of land known as the Marywood Subdivision. The Marywood Subdivision, located on the south side of Terre Haute consisted of about 68 acres comprising about 300 residential lots. At his death in 1971, Leonard Hirt, a friend of John's, was president and director of Marywood. In 1972, John was elected director of Marywood to fill the vacancy created by Leonard Hirt's death. John accepted the directorship because it came at the request of the Hirt family (who were the remaining shareholders of Marywood) and because he was familiar with the business. John served as a director of Marywood until HBC bought the Marywood stock in 1977, and for some time afterward.

From 1972 to 1977, Marywood actively developed and sold lots in the Marywood Subdivision and, using the construction services of HBC, built a sewer for the subdivision. The sewer construction was financed through loans from Merchants National Bank (hereinafter sometimes referred to as Merchants) and HBC. HBC also loaned money to Marywood to help make payments on a mortgage.

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[3] So stipulated. HBC's 1977 tax return includes a statement that HBC's subchapter S election was made on "12-23-66". Under sec. 1372(c) (present law sec. 1362(c)), an election made on Dec. 23, 1966, would have first taken effect for 1967.

[4] During 1977, John owned 1,600 shares (80 percent) of the total outstanding stock of HBC and Francis owned the remaining 400 shares (20 percent).

From the time of Leonard Hirt's death until 1977, Marywood faced serious business problems and litigation; in 1977, it was approaching bankruptcy. Marywood was in arrears in its interest obligations to Merchants and was overdue on its debt to HBC. In addition, Marywood owed significant attorneys fees and insurance premiums, and was a defendant in a lawsuit. Because of Marywood's impending bankruptcy, its shareholders decided to sell the Marywood stock.[5] On June 18, 1977, John (on behalf of HBC) negotiated and executed an agreement with John Hirt (on behalf of the Marywood shareholders), pursuant to which HBC would pay each of the Marywood shareholders $10,115.28 and would assume all the Marywood obligations and liabilities; in exchange therefor, HBC would acquire all the Marywood stock and receive all the Marywood assets.

HBC had three reasons for buying the Marywood stock. First, John believed the sewer system could be sold to the Sanitary District. Second, since Marywood was heavily indebted to HBC, the sale of the sewer system and the completion of the development of the subdivision as commercial land would provide a means for HBC to recoup the debt owed to it by Marywood. Third, although HBC purchased the Marywood stock to acquire the Marywood assets, HBC chose to effect the transfer of the assets in the form of a stock acquisition because (1) the Marywood shareholders declined to sell the assets directly, (2) a direct sale of the assets would trigger the immediate repayment of a mortgage on certain assets, and (3) John believed that HBC would become involved in the litigation pending against Marywood if HBC acquired the assets rather than the stock of Marywood. The June 18, 1977, agreement was performed and HBC acquired all of the Marywood stock.[6]

After HBC acquired the Marywood stock, a number of events occurred with respect to Marywood's corporate affairs. The Marywood board of directors held a special meeting on June 18, 1977, pursuant to which the then

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[5] John advised the Hirt family that it could sell the sewer system to the City of Terre Haute Sanitary District (hereinafter sometimes referred to as the Sanitary District), which under State law was required to buy the system, in order to raise money to meet Marywood's obligations. However, the Hirt family did not believe that the Sanitary District had to buy the sewer system, and did not agree to sell the system.

[6] So stipulated. No Marywood stock certificates were issued to HBC in connection with the June 18, 1977, agreement.

Marywood directors and officers (other than John) resigned and were replaced by representatives of HBC.

On February 1, 1978, HBC executed a proxy, appointing John to represent HBC and to vote all of its stock in Marywood at the 1978 annual meeting or, alternatively, to execute a written consent to resolutions of the Marywood shareholders in lieu of the annual meeting. Thereupon, John executed such a written consent naming the new directors of Marywood for a 1-year term and the directors of Marywood also formally consented to the resolution of the board of directors in lieu of the annual meeting of the board, naming the new officers of Marywood for a 1-year term.

On May 2, 1978, the Marywood board of directors, through a written consent to resolutions, consented to the sale of one of the Marywood Subdivision lots to John's son, John W. Haley, Jr. (hereinafter sometimes referred to as John, Jr.), for $36,800.[7] Thereupon, Marywood, as grantor, executed a corporate warranty deed to John, Jr., and his wife. Indiana Savings & Loan Association, John, Jr.'s mortgagee, paid $25,587.80 of the purchase price to Marywood in consummation of this sale.[8] This is the only residential real estate lot that Marywood sold after June 18, 1977.

On September 15, 1978, the Marywood board of directors held its quarterly meeting and discussed Marywood's financial status.

On November 22, 1978, as a result of respondent's examining agent's raising the issue of HBC's subchapter S corporation status, HBC held a special meeting of its board of directors in which it determined that Marywood would be liquidated and dissolved pursuant to State law. On that same date, Marywood's and HBC's boards of directors consented to Marywood's dissolution. On or about December 11, 1978, Marywood filed Form 966, Notice of Corporate Dissolution or Liquidation, with the Internal Revenue Service. On December 27, 1978, Marywood, as grantor, executed a Deed, Conveyance, and Bill of Sale transferring all its properties to HBC. Marywood then executed two confirming warranty deeds on February 9, 1979, with respect to real estate held by it, and caused the deeds to be filed on March 26, 1979, with the Vigo County, Indiana, Recorder's Office. Thereupon, on May 10, 1979, the Certificate of Dissolution of Marywood was filed with the Secretary of State of Indiana.

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[7] A house had been built on the lot by HBC for which HBC provided the funds.

[8] The May 2, 1978, consent was "for the sum of Thirty-Six Thousand Eight Hundred Dollars ($36,800.00) cash". The record in the instant case does not indicate how the remaining $11,212.20 was paid.

Marywood timely filed Federal and Indiana income tax returns for 1977 and 1978. On its 1977 Federal income tax return (filed August 18, 1978), Marywood reported interest income of $87.28, deductions of $15,435.84 comprising taxes, interest, and various office expenditures, a net operating loss of $15,348.56, and, thus, no tax liability for that year. On its 1978 Federal income tax return (filed March 19, 1979), Marywood did not show any gross income, taxable income, or tax liability, but rather stated that HBC acquired all the Marywood assets and liabilities and that HBC would report all transactions on its 1978 tax returns.

John never intended to have Marywood operate as an independent corporate venture once HBC acquired control of Marywood; he planned eventually to liquidate Marywood. Notwithstanding this intention, however, John chose not to dissolve Marywood formally in accordance with State law immediately upon acquisition of the stock because he first wanted to improve Marywood's financial condition before dissolving the corporation. John was concerned that to do otherwise would result in significant litigation being filed against him as well as causing the requirement of immediate repayment of certain debts.

Before HBC began the formal process of liquidating Marywood, HBC took steps to advise Marywood's creditors that bills would be paid and then, in fact, actually paid the bills shortly thereafter. Thus, after the acquisition of the Marywood stock, attorneys fees were paid, overdue interest on bank loans was paid, litigation was settled, the sewer system was sold to the Sanitary District, and an outstanding mortgage to Merchants was paid. Marywood did not have any taxable income during this period.[9] The proceeds from the sale of the real estate to John, Jr., were deposited in Marywood's checking account. Because the real estate was sold at cost, no gain from the sale was reported on HBC's tax return.

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[9] Marywood's 1977 interest income ($87.28) was received before HBC acquired Marywood's stock. There is no evidence as to whether Marywood's 1977 expenses ($15,435.84) were paid or incurred before this acquisition. Marywood's 1977 tax return shows that Marywood did not have any taxable income in 1976, 1975, and 1974, as well as 1977.

HBC chose to retain a checking account that had been maintained at Merchants in Marywood's name from the time of Marywood's incorporation in 1962.[10] After HBC acquired Marywood's stock, HBC deposited some of its funds into Marywood's checking account in order to pay the preacquisition Marywood debts described above, since the account did not have enough funds to pay these debts. John retained this Marywood checking account in order to assure Merchants, the mortgagee on the Marywood Subdivision mortgage, that Marywood was not going to default on its debt.

After June 18, 1977, not all of Marywood's preacquisition debts were paid directly from Marywood's checking account; rather, some were paid directly by HBC to Marywood's creditors. HBC's bookkeeper, who was in charge of Marywood's checking account after June 18, 1977, did not maintain complete books and records for Marywood as she did for HBC. Moreover, because Marywood's records were intermingled with HBC's records, she was unable to identify those transactions in which HBC paid Marywood's debts and those transactions in which Marywood's debts were paid through the Marywood checking account. In fact, the determination as to whether HBC would pay a preacquisition debt of Marywood or whether the debt would be paid through Marywood's checking account depended solely on whether there was enough money in Marywood's checking account. That is, if there was money in Marywood's checking account, the debt would be paid through the account. If not, then HBC would either transfer money to the account or pay the debt directly.

Before the stock acquisition, Marywood owed money to HBC and this debt was shown as an account receivable on HBC's books and records.

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[10] The account was finally closed out by HBC on Sept. 7, 1979, several months after the dissolution of Marywood under State law, and the remaining balance was transferred to the HBC checking account.

On November 30, 1977, HBC's accountant transferred $32,984.80 from accounts receivable to the account for HBC's investment in Marywood. On December 31, 1978, HBC's accountant transferred $47,569 from accounts receivable to the account for HBC's investment in Marywood. The balance sheets attached to HBC's tax returns for 1977, 1978, and 1979 reflect HBC's investment in Marywood (as well as several other corporations) comprising Marywood's expenses paid by HBC, the transfer of loans owed HBC by Marywood from HBC's accounts receivable, and the cost of the stock paid by HBC to the Marywood shareholders. HBC's 1977 tax return (filed March 14, 1978) refers to the item as an investment in "Marywood Corp."; its 1978 and 1979 returns use the term "Marywood Division".

In preparing tax returns for Marywood, the accountant reported income, expenses, and a net operating loss for 1977 on Marywood's tax returns, but 1978 income and expenses, if any, incurred for Marywood on HBC's 1978 tax returns. A claim for refund in the amount of $387, however, was made by Marywood on its 1978 Indiana State return and subsequently was allowed by the State of Indiana.

When HBC acquired Marywood (June 18, 1977), HBC intended to liquidate Marywood at some time; however, HBC did not form an intent to liquidate Marywood promptly until the fall of 1978, as a result of respondent's examining agent's raising the issue of HBC's subchapter S corporation status.

OPINION

Under section 1372(b)(1),[11] a subchapter S corporation generally is not subject to the corporate income tax;

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[11] SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

(b) EFFECT.—If a small business corporation makes an election under subsection (a), then—

(1) with respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter * * *

[The subsequent revision of this provision by sec. 2 of the Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669, does not affect the instant case. Provisions similar to the former sec. 1372(b)(1) appear in sec. 1363(a), applicable to taxable years beginning after Dec. 31, 1982 (sec. 6(a) of the act).]

instead, under section 1373(a),[12] the corporation's income
taxed to the shareholders. Concomitantly, when
subchapter S corporation makes a qualified investmen
section 48(e)[13] provides that the qualified investment
passed through to the shareholders for purposes of calcula
ing the investment credit allowed by section 38.

Under section 1372(e)(3)[14] if a corporation ceases to be
small business corporation, as defined in section 1371(a),
then the corporation loses its subchapter S corporatio
status and its income, deductions, and credits are taxed

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[12] SEC. 1373. CORPORATION UNDISTRIBUTED TAXABLE INCOME TAXED
SHAREHOLDERS.

(a) GENERAL RULE.—The undistributed taxable income of an electing small busine
corporation for any taxable year shall be included in the gross income of the shareholders
such corporation in the manner and to the extent set forth in this section.

[The subsequent revision of this provision by sec. 2 of the Subchapter S Revision Act of 198
Pub. L. 97-354, 96 Stat. 1669, does not affect the instant case. Provisions similar to t
former sec. 1373(a) appear in 1366(a)(l)(A), applicable to taxable years beginning after Dec. 3
1982 (sec. 6(a) of the act).]

[13] SEC. 48. DEFINITIONS; SPECIAL RULES.

(e) SUBCHAPTER S CORPORATIONS.—In the case of an electing small business corporation (
defined in section 1371)—

(1) the qualified investment for each taxable year shall be apportioned pro rata among t
persons who are shareholders of such corporation on the last day of such taxable year; a

(2) any person to whom any investment has been apportioned under paragraph (1) shall
treated (for purposes of this subpart) as the taxpayer with respect to such investment, a
such investment shall not (by reason of such apportionment) lose its character as
investment in new section 38 property or used section 38 property, as the case may be.

[The subsequent repeal of this provision by sec. 5(a)(7) of the Subchapter S Revision Act
1982, Pub. L. 97-354, 96 Stat. 1669, 1692, does not affect the instant case. Provisio
encompassing the substance of the former sec. 48(e) appear in secs. 1366(a)(1)(A) and 1366(
applicable to taxable years beginning after Dec. 31, 1982, (sec. 6(a) of the act).]

[14] SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

(e) TERMINATION.—

* * * * * * *

(3) CEASES TO BE SMALL BUSINESS CORPORATION.—An election under subsection (a) made by
small business corporation shall terminate if at any time— * * * the corporation ceases
be a small business corporation (as defined in section 1371(a)). Such termination shall
effective for the taxable year of the corporation in which the corporation ceases to be
small business corporation and for all succeeding taxable years of the corporation.

[The subsequent revision of this provision by sec. 2 of the Subchapter S Revision Act of 198
Pub. L. 97-354, 96 Stat. 1669, does not affect the instant case. Provisions similar to t
former sec. 1372(e)(3) appear in sec. 1362(d)(2), applicable to taxable years beginning after De
31, 1982 (sec. 6(a) of the act).]

[15] SEC. 1371. DEFINITIONS.

(a) SMALL BUSINESS CORPORATION.—For purposes of this subchapter, the term "small busine
corporation" means a domestic corporation which is not a member of an affiliated group (
defined in section 1504) * * *

[The subsequent revision of this provision by sec. 2 of the Subchapter S Revision Act of 198
Pub. L. 97-354, 96 Stat. 1669, does not affect the instant case. Provisions similar to t
former sec. 1371(a) appear in sec. 1361(b)(2)(A), applicable to taxable years beginning aft
Dec. 31, 1982 (sec. 6(a) of the act).]

the corporation and not passed through to the shareholders. Section 1371(a) provides that a subchapter S corporation may not be a member of an affiliated group, as defined in section 1504.[16] Section 1371(d)[17] provides a special definition, that for purposes of section 1371(a), a subchapter S corporation will not be considered a member of an affiliated group for a taxable year because of its ownership of a controlled corporation if the controlled corporation (1) has not yet begun business since its incorporation and before the close of the taxable year, and (2) has no taxable income for the period included within the subchapter S corporation's taxable year.

Respondent contends that petitioners are not allowed to pass through HBC's income and investment tax credits for 1977 because HBC's subchapter S corporation status terminated under section 1372(e)(3) during 1977; accordingly, HBC is subject to corporate income taxes for 1977. Respondent maintains that this is so because HBC became a member of an affiliated group as a result of HBC's acquisition of 100 percent of the Marywood stock on June 18, 1977. Moreover, respondent maintains that the exception provided in section 1371(d) for acquisitions of inactive corporations does not apply in the instant case because Marywood was actively engaged in business after its incorporation and, after its acquisition by HBC, Marywood did not become an inactive corporation whose separate corporate existence is to be ignored.

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[16] SEC. 1504. DEFINITIONS.

(a) Definition of "Affiliated Group".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends, employer securities within the meaning of section 301(d)(9)(A) of the Tax Reduction Act of 1975, or qualifying employer securities within the meaning of section 4975(e)(8) while such securities are held under an employee stock ownership plan which meets the requirements of section 301(d) of such Act or section 4975(e)(7), respectively.

[The subsequent revision of this provision by sec. 60(a) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 577, applicable to taxable years beginning after Dec. 31, 1984 (sec. 60(b)(1) of Pub. L. 98-369), does not affect the instant case.]

[17] SEC. 1371. DEFINITIONS.

(d) Ownership of Certain Stock.—For purposes of subsection (a), a corporation shall not be considered a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

(1) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

(2) does not have taxable income for the period included within such taxable year.

[The subsequent revision of this provision by sec. 2 of the Subchapter S Revision Act of 1982, Pub. L. 97-354, 96 Stat. 1669, does not affect the instant case. Provisions similar to the former sec. 1371(d) appear in sec. 1361(c)(6), applicable to taxable years beginning after Dec. 31, 1982 (sec. 6(a) of the act).]

On brief, petitioners concede that—

> by the express statutory language of the IRC, it is apparent that the fact that Haley [HBC] in 1977 acquired all of the capital stock of Marywood, made Haley and Marywood an "affiliated group" and terminated Haley's election to be taxed as a small business corporation.

Petitioners also concede that "the exception provided for in *IRC Section 1371(d)* does not apply in the case at bar." (Emphasis in original.) They contend, however, that we should not hold that HBC and Marywood constitute an affiliated group, because (1) "the separate formal corporate existence of Marywood as a subsidiary of Haley [should] be ignored", and (2) HBC's acquisition of Marywood's stock should be treated as an acquisition of Marywood's assets, especially since HBC complied with the requirements of sections 332 and 334(b)(2) by liquidating Marywood within 2 years after acquiring Marywood's stock.

We agree with respondent that HBC became affiliated with Marywood on June 18, 1977, and, thus, HBC's subchapter S corporation status terminated for 1977.

Subchapter S was added to the Code by section 64(a) of the Technical Amendments Act of 1958, Pub. L. 85-866, 72 Stat. 1606, 1650. The Senate Finance Committee report stated generally that "The right to elect the treatment provided under this new subchapter is limited to what are defined as small business corporations. These corporations must be domestic corporations which are not eligible to file a consolidated return with any other corporation. * * * [T]he election as to the treatment under this new subchapter is to be terminated if the corporation ceases to qualify as a small-business corporation." S. Rept. 85-1983, at 88-89 (1958), 1958-3 C.B. 992, 1009-1010. See also H. Rept. 85-2632 (Conf.), at 36 (1958), 1958-3 C.B. 1188, 1223.

The regulations promulgated under section 1371 make it clear that whether or not the corporations actually file consolidated returns is irrelevant;[18] the sole criterion in determining affiliation, for subchapter S corporation purposes, is the requisite stock ownership.

In an effort to clarify further that a small business corporation could not be a member of an affiliated group, the Congress, in the same legislation that gave rise to section 1371(a), also amended section 1504(b) by adding a new paragraph (8). That amendment provided that the definition of "includible corporation," for purposes of section 1504(a), would not include an electing small business corporation as defined in section 1371. It was subsequently recognized that the amendment was drafted in such a way as to allow small business corporations to be members of affiliated groups. Thus, the Congress repealed paragraph (8) of subsection 1504(b) (sec. 2(c) of Pub. L. 86-376, 73 Stat. 699 (1959)). At the time this repeal was being considered, Senator Byrd of Virginia provided the following additional reasoning for disallowing small business corporations from being members of affiliated groups:

> Subsection (c) strikes out paragraph (8) of section 1504(b) of the code and thereby clarifies the definition of a small business corporation. The existing statute defines a small business corporation as one which, among other things, is not a member of an affiliated group. *This rule is intended to preclude the accumulation of corporate earnings in a subsidiary and thus avoid the taxation of those earnings to the shareholders of the subchapter S corporation.* However, paragraph (8) of section 1504(b), which was enacted to insure this result, actually has the opposite effect by permitting the acquisition of a subsidiary by a small business corporation after the election has been made. This amendment would prevent acquisition of an 80-percent-owned subsidiary at any time. Subsection (c) would take effect on the day after the date of enactment of this act. [105 Cong. Rec. 18898 (Sept. 10, 1959). Emphasis added.]

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[18] Sec. 1.1371-1. Definition of small business corporation.

(a) *In general.* For purposes of subchapter S, chapter 1 of the Code and sections 1371 through 1.1378-3, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group of corporations (determined in accordance with paragraph (c) of this section) * * *

* * * * * * *

(c) *Member of an affiliated group.* (1) Except as otherwise provided in subparagraph (2) of this paragraph, a corporation which is a member of an affiliated group of corporations, as defined in section 1504, is not a small business corporation, whether or not such affiliated group has ever filed a consolidated return. * * *

In the Revenue Act of 1964, the Congress carved out
exception to the general rule of section 1371(a) by enactin
section 1371(d). The report of the Senate Finance Commi
tee on the 1964 Act explains the law as follows (S. Rep
88-830, at 146-147 (1964), 1964-1 C.B. (Part 2) 50
650-651):[19]

> 42. Small business corporations: Ownership of certain stock disregard
> (sec. 235(a) of the bill and sec. 1371 of the code)
>
> (a) *Present law.*—In 1958 Congress added to the Internal Revenue Co
> a new subchapter (sec. 1371 and following) * * *
>
> The right to elect the treatment provided under the new subchapt
> was limited to small business corporations in part because of t
> complexity involved in passing the earnings of a corporation through
> its shareholders where the stock of the corporation is held by a wide
> diversified group of shareholders, and in part because it was thought th
> only the relatively small corporations were essentially comparable to t
> partnership or proprietorship where the earnings are taxed to the owne
> rather than to the business organization. As a result, Congress provid
> that corporations making this election must be domestic corporatio
> which are not eligible to file a consolidated return with any oth
> corporation. * * *
>
> (b) *General reasons for provision.*—Situations have been called to yo
> committee's attention where corporations are denied the privilege
> electing to have their income taxed to their shareholders (rather than
> the corporation) merely on the grounds that the corporation owns t
> stock of completely inactive subsidiaries.
>
> The establishment of inactive subsidiaries is a common busine
> practice for corporations planning for future growth. Such corporatio
> often desire to reserve their corporate name in States in which they a
> not yet doing business by establishing subsidiaries with the same or
> similar name to that of the parent corporation. Your committee sees
> reason to penalize the parent corporation by denying it the privilege
> electing to pass the income through to its shareholders for tax purpos
> merely because, for business reasons, it has established these inacti
> subsidiaries which constitute an affiliated group which could file
> consolidated return.
>
> (c) *General explanation of provision.*—As a result of the consideratio
> set forth above, this provision adds a new subsection to section 1371
> the code providing that a corporation will not be considered a member
> an affiliated group for purposes of this election (and, therefore, not
> denied the right to elect subch. S status) merely because it owns stock
> another corporation which is inactive. An inactive corporation, *in th*
> *case*, is one that has not begun business after the date of i

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[19] The text of sec. 235(a) of H.R. 8363, as reported by the Senate Finance Committee, whi
is described in this extract from the committee report, is identical to sec. 233(a) of t
Revenue Act of 1964, Pub. L. 88-272, 78 Stat. 19, 112. See H. Rept. 88-1149 (Conf.), at 1
51-52 (1964), 1964-1 C.B. (Part 2) 774, 788, 824-825.

> incorporation and before the end of the parent corporation's taxable year in question and that does not have taxable income for this taxable year. If these conditions are met and the parent is not affiliated with any other corporation, an election may be filed under subchapter S by the parent corporation despite the rule that a subchapter S corporation may not be a member of an affiliated group. However, if the subsidiary corporation does not meet the conditions set forth above in a subsequent year, the parent corporation's subchapter S status would be terminated at that time. [Emphasis added.]

The 1964 Act amendment was a congressional response to a limited problem. Although the Congress recognized the plight of subchapter S corporations with inactive subsidiaries, it chose to grant relief only where the inactive subsidiaries met the rigorous requirements of section 1371(d). We note that the Congress carefully tailored the relief so that it applies only where it would be impossible to have what Senator Byrd described in the 1959 Act debate as "the accumulation of corporate earnings in a subsidiary and thus avoid the taxation of those earnings to the shareholders of the subchapter S corporation." 105 Cong. Rec. at 18898.

The approach that the Congress has used in this regard is prophylactic; i.e., the possibly abusive situation is prohibited without regard to whether an abuse has occurred. For example, it is irrelevant whether the subsidiary has only losses and so there is no improper "accumulation of corporate earnings". Similarly, if the subsidiary had conducted business before being acquired by the subchapter S corporation (or before the subchapter S election had been made), then it is irrelevant that the subsidiary is not in business during the period that it is a subsidiary of a subchapter S corporation.

One might argue that the Congress made the wrong choice. Alternatively, one might argue that, if the Congress had been presented with the factual situation of the instant case, then the Congress would have provided relief broad enough to cover the instant case. However, the reality we face is that (1) the policy choice is to be made by the Congress, and (2) as petitioners concede, HBC does not qualify for relief under the provision that the Congress chose to enact. Even if we were to agree that the Congress should make the relief of section 1371(d) more widely available, or that the Congress would have made the relief available to situations such as that in the instant case if only the matter had been presented, we do not have authority to change the law that the Congress enacted. See, e.g., *Reed v. Commissioner*, 82 T.C. 208, 213-214 (1984), and cases there cited.

We conclude that HBC's ownership of Marywood may not be disregarded, because Marywood did not satisfy the requirements of section 1371(d) during 1977. Marywood's essentially inactive status does not change our conclusion. HBC's, or John's, intention to liquidate Marywood does not change our conclusion.

The conclusion we reach comports with the case law that has developed in this area. In *May v. United States*, 644 F.2d 578 (6th Cir. 1981), revg. an unreported case (E.D. Ky. 1978, 42 AFTR 2d 78-5328, 78-2 USTC par. 9564), the Court of Appeals held that the subchapter S election was not available to a corporation that, pursuant to an earlier asset acquisition from another corporation, had acquired 100 percent of the stock of a subsidiary of the selling corporation. The court agreed with the District Court's rejection of the plantiff's alternative arguments that there had been a practical liquidation of the subsidiary and that the subsidiary had not begun business for purposes of section 1371(d). However, the Court of Appeals disagreed with the District Court's conclusion that, despite the fact that the subsidiary had begun business within the meaning of section 1371(d), its corporate identity should be disregarded because the subsidiary had become inactive and because the parent had acted towards the subsidiary's property as if it were the owner. The Court of Appeals concluded as follows (644 F.2d at 580):

> It is also clear that Oldsmar [the subsidiary] had "begun business" within the meaning of sec. 1371(d). * * * That *Oldsmar may have become inactive after its acquisition by Florida Downs [the subchapter S corporation] is irrelevant*; the beginning of business "at any time after the date of incorporation" and before the close of the tax years in question precludes reliance on sec. 1371(d).
>
> We disagree, however, with the District Court's conclusion that Oldmar's corporate identity should be disregarded. Florida Downs was free to organize its affairs as it chose. It did so in a manner which made it a member of an affiliated group. Having made that decision, the

> shareholders of Florida Downs "must accept the tax consequences of [their] choice, whether contemplated or not." *Commissioner v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 149 * * * [Emphasis added.]

In *Barnes Motor & Parts Co. v. United States*, 309 F. Supp. 298 (E.D. N.C. 1970), the court agreed with the United States that the affiliated group requirements of section 1371(a) must be strictly construed. (309 F. Supp. at 303.) The court thus held that a corporation's election to be a subchapter S corporation was void from its inception, even though the corporation, after its subchapter S election but before the years in issue, disposed of 60 percentage points of the 87½-percent stock ownership it held in a subsidiary corporation. Moreover, the court stated that even if it were to disregard the disqualifying stock ownership at the time of the election because the corporation remedied this defect before the years in issue, the court would disallow subchapter S corporation status on grounds that the corporation controlled another subsidiary for almost 3 months during one of the years in issue. In so holding, the court stated as follows (309 F. Supp. at 304):

> Although the ownership of the subsidiary was merely a temporary arrangement which was part of a plan of liquidation, the plaintiff carried out the plan apparently without consideration for the consequences it might have on the Subchapter S election. The Court therefore feels that such manipulation offers further grounds to support the finding that the plaintiff did not meet the statute's affiliated-group requirement.

As was the case in *May*, Marywood had begun business after its incorporation and, thus, the narrow exception to the general rule of nonaffiliation is inapplicable here. Petitioners chose, for proper business reasons, to organize its affairs by keeping Marywood in existence. As in *Barnes Motor*, petitioners in the instant case apparently did not consider the consequences the continued existence of Marywood would have on HBC's subchapter S status. However, having made the decision to acquire Marywood's stock rather than Marywood's assets, petitioners must accept the tax consequences of their choice. Thus, we will not disregard HBC's stock ownership of Marywood.[20]

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[20] In *Coca-Cola Bottling Co. of Gallup v. United States*, 443 F.2d 1253 (10th Cir. 1971), the Court of Appeals refused to disregard the separate corporate status of a subsidiary of a

While it is well established that the economic substance will control the tax consequences rather than the form, (*Helvering v. Lazarus & Co.*, 308 U.S. 252 (1939)), "We will not relieve a party from the tax consequences of the form in which he or she appears to have molded a transaction, in the absence of proof that that form does not properly reflect the transaction." *Yamamoto v. Commissioner*, 73 T.C. 946, 954 (1980), affd. without published opinion 672 F.2d 924 (9th Cir. 1982).

In *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579-580 (1977), the Supreme Court, albeit in a somewhat different context, gave the following guidance:

> 2. The taxpayer suggests that the transaction equates with a payment of cash to the trustees followed by a loan, evidenced by the note in return, in the amount of the cash advanced. But
>
> "a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred.
>
> " * * * This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Commissioner v. National Alfalfa Dehydrating*, 417 U.S. 134, 148-149 * * * (1974).
>
> See *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673, 690 * * * (1974). What took place here is clear, and income tax consequences follow accordingly. We do not indulge in speculating how the transaction might have been recast with a different tax result. [Fn. ref. omitted.]

Petitioners chose to follow the form of buying Marywood, rather than buying Marywood's assets, and did so for valid nontax reasons. Petitioners chose to follow the form of keeping Marywood in existence, and did so for valid nontax reasons.

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corporation that claimed it was a subchapter S corporation. The Court of Appeals stated as follows (443 F.2d at 1254):

"To sustain their position that Gallup Company [the subsidiary] was a sham, counsel cite a number of cases, e.g., *Shaw Construction Company v. Commissioner of Internal Revenue*, 9 Cir., 323 F.2d 316, where the challenge to the corporate entity was made by the taxing authorities. The Commissioner has greater freedom and responsibility to disregard the corporate entity than does either that corporate entity or its creator. See *Commissioner of Internal Revenue v. State-Adams Corporation*, 2 Cir., 283 F.2d 395, 398-399, cert. denied 365 U.S. 844, 81 S.Ct. 802, 5 L.Ed.2d 809. In our opinion, Gallup Company was organized for a business purpose, carried on business activities, and received taxable income. It cannot escape federal income tax liability on the theory that it was a sham."

We do not find in the record of the instant case any justification for giving petitioners the tax benefits that would have been available if they had acted differently. The tax consequences—loss of subchapter S status and the matters that flow from this loss—are those that follow from the choices petitioners made. Petitioners make an alternative argument, that there was a practical liquidation of Marywood at the time HBC acquired it, such that the acquisition, in reality, was one of assets rather than stock. Thus, petitioners argue that we need not ever reach the question of affiliation under section 1371(a). We cannot agree with this view. Rather, we conclude that, notwithstanding petitioners' intent to liquidate Marywood eventually, no such liquidation occurred on June 18, 1977, because, as noted above, there was a business purpose for the continued existence of Marywood. Moreover, we conclude that Marywood was operated after the June 18, 1977, acquisition in accordance with that business purpose.

In *May v. United States*, *supra*, the Court of Appeals agreed with the District Court's rejection of the plaintiffs' claim that there had been a practical liquidation of a corporate subsidiary such that there was no affiliation under section 1371(a) (644 F.2d at 579), thereby implicitly approving the following analysis of the District Court (*May v. United States*, 42 AFTR2d at 78-5329—78-5330, 78-2 USTC par. 9564 at 84,760) on the "practical liquidation" issue:

> While it has been held that a liquidation does not require a formal declaration of same, if the shareholders have adopted a plan of liquidation and enacted it, *Alameda Realty Corp. v. Commissioner*, 42 T.C. 273 (1964), this Court finds neither a formal declaration nor a de facto liquidation in this instance. Title to the property was retained by Oldsmar, tax returns were filed by Oldsmar, stock in the corporation was transferred and the corporation did in fact retain its corporate identity.

In *May*, the subsidiary was acquired by the subchapter S corporation in 1969. Although the subsidiary filed income tax returns for 1969, 1970, and 1971, it reported no income; its tax returns bore the notation "CORPORATION INACTIVE". The subsidiary did not have any office, bank account, or employees. It did not negotiate any lease or receive any rent. The subchapter S corporation paid all expenses relating to the property that the subsidiary owned.

As in *May*, in the instant case no formal plan of liquidation was adopted until November 22, 1978. Marywood, after the acquisition of its stock by HBC, held real property, maintained a checking account, sold real estate, complied with statutory corporate formalities, paid expenses, and filed tax returns. Moreover, the continued corporate existence of Marywood subsequent to June 18, 1977, served a business purpose in that it prevented HBC from becoming liable on a mortgage and in pending litigation. Thus, we cannot say that there was a practical liquidation of Marywood such that HBC, in reality, acquired the assets of Marywood rather than its stock.

Petitioners draw our attention to several Revenue Rulings that appear to bear on the issue in the instant case. In Rev. Rul. 73-496, 1973-2 C.B. 312, respondent chose to ignore (for purposes of section 1371(a)) a 30-day period during which a subchapter S corporation controlled a subsidiary which was liquidated under section 334(b)(2). Respondent maintains that his ruling is correct but that we should draw a line between the ruling's 30-day relationship and the instant case's 2-year relationship. Yet in analogous circumstances, involving interpretation of the same definition we seek to apply in the instant case—affiliated group within the meaning of section 1504—respondent first approved ignoring a 30-day relationship (Rev. Rul. 70-391, 1970-2 C.B. 3) and then explicitly "clarified" his earlier ruling so that, as so clarified, respondent approved ignoring a 2-year relationship. (Rev. Rul. 73-461, 1973-2 C.B. 10.) Respondent has already ventured onto this slippery slope; indeed, he has already slipped past the point that petitioners would have us reach. We do not regard any of these three rulings as being consistent with the statute as enacted by the Congress in 1958 and as modified and explained by the Congress in 1959 and 1964. We need not deal in the instant case with the "momentary" relationship problem of Rev. Rul. 72-320, 1972-1 C.B. 270. We will not draw a line between the instant case and the 30-day period of Rev. Rul. 73-496. We hold that the statute forbids us to ignore HBC's relationship with Marywood. Our analysis would be the same if this relationship had lasted only 30 days.[21]

Finally, petitioners contend that their position is supported by Indiana's decision to refund the $387 gross income tax apparently paid by Marywood in 1978 in connection with John, Jr.'s purchase of a Marywood Subdivision lot. Their argument is that, under Indiana law, a subchapter S corporation is not liable for this tax, HBC was a subchapter S corporation, Marywood was not then a subchapter S corporation, Indiana refunded the tax, and so Indiana must have recognized that Marywood's existence should be ignored and HBC was the real grantor of the lot to John, Jr.

The parties have stipulated that Marywood's board of directors consented to the sale. Marywood is the grantor on the deed. The mortgagee bank's check is payable to Marywood. We do not know what analysis was followed by the Indiana tax officials in apparently first requiring Marywood to pay the tax and then refunding the tax. We do not give significant weight to this $387 payment and reimbursement in considering the $50,000 status issue before us.

We hold for respondent on this issue.

Decision will be entered for the respondent.[22]

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[21] In any event, as we recently stated in *Stark v. Commissioner*, 86 T.C. 243, 250-251 (1986):

"Absent special circumstances, a revenue ruling merely represents the Commissioner's position with respect to a specific factual situation. See *Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146-1147 (5th Cir. 1971); *Crow v. Commissioner*, 85 T.C. 376, 389 (1985), and cases cited therein. * * * Whereas this Court or any other court may adopt the conclusion and rationale of a revenue ruling, revenue rulings typically do not constitute substantive authority for a position. * * * "

[22] In their petition, petitioners contend that, if we were to hold that HBC's subchapter S status terminated in 1977, then HBC should be entitled to deduct for 1977 the Indiana income tax for which it would become liable. At trial, we brought this matter to petitioners' attention. Petitioners indicated that they had no evidence on this point. Petitioners' briefs do not deal with this point. We deem petitioners to have conceded this point.

Frank DeMarco and Jacquelyn DeMarco, Petitioners v. Commissioner of Internal Revenue, Respondent

Docket No. 2002-85. Filed August 25, 1986.

In 1973, petitioners purchased an old factory building, placed it in service, and sometime thereafter leased it to a manufacturing company. In 1982, they completed and placed in service improvements to the building which cost $360,294. Petitioners, on their original 1982 income tax return, did not in any way account for depreciation of the improvements. On an amended 1982 return filed on Sept. 23, 1983, they depreciated the improvements using the accelerated method embodied in the table in sec. 168(b)(1), I.R.C. 1954, and the "applicable percentage" indicated therein for the first year of a 5-year recovery period. In addition, they claimed on that return a 20-percent rehabilitation credit under sec. 38, I.R.C. 1954. *Held*: Petitioners did not make the election to use straight line depreciation upon which entitlement to a rehabilitation credit depends and thereby are ineligible for the rehabilitation credit claimed. Under sec. 46(a)(2)(A)(iv) and sec. 46(a)(2)(F), a credit against tax is allowed for "qualified rehabilitation expenditures". Such expenditures, as defined in sec. 48(g)(2)(B)(i), do not include "expenditures with respect to which an election has not been made under sec. 168(b)(3) (to use the straight-line method of depreciation)". The making of an election under sec. 168(b)(3) to depreciate "by use of the straight line method" is governed by sec. 168(f)(4). Under sec. 168(f)(4)(B)(i) an election provided for in sec. 168 must "be made on the taxpayer's return * * * for the taxable year concerned". Since petitioners in their original return did not depreciate the improvements at all and on their amended return depreciated the improvements using the accelerated method described in sec. 168(b)(1), they did not make the required straight line depreciation election on their 1982 income tax return, even assuming (but not deciding) that the amended return as well as the original return may be taken into account. Accordingly, petitioners do not qualify for the rehabilitation credit claimed.

William T. Appleyard, for the petitioners.

Mae J. Lew, for the respondent.

OPINION

RAUM, *Judge*: The Commissioner determined a deficiency n petitioners' 1982 income tax in the amount of $48,081. The sole issue for decision is whether petitioners are entitled to a credit under section 38, I.R.C. 1954, in the amount allowed by section 46(a)(2)(F) with respect to property qualifying under section 48(g) as a rehabilitated building. Resolution of this issue requires a determination of whether petitioners made an election under section 168(b)(3) to use the straight line method of depreciation with respect to their rehabilitation expenditures. Entitlement to the rehabilitation credit is, in section 48(g)(2)(B), conditioned on the petitioners' giving up the benefits of the accelerated method of depreciation described in section 168(b)(1) and (2) of the Accelerated Cost Recovery System (ACRS) by electing, under section 168(b)(3), to use the optional straight line method of depreciation described therein. The case was submitted fully stipulated.

At the time the petition herein was filed, petitioners were husband and wife residing in Winthrop, Massachusetts.

In 1973, petitioners purchased and placed in service an old factory building located in Everett, Massachusetts. They leased this building to the Middlesex Manufacturing Co., of which petitioner-husband is the majority stockholder and petitioners' children are the owners of the remaining outstanding stock. In 1982, petitioners made the improvements to the building which give rise to the present controversy. These improvements cost petitioners $360,294. They were completed and placed in service in November of 1982.

Petitioners filed a joint Federal income tax return (the original return) and an amended return for the year 1982. On both returns, they reported on Schedule E "Rents received" from the factory building in the amount of $60,000. On Schedule E in their original return they deducted $14,066 depreciation from the "Rents received". This $14,066 depreciation was shown on Form 4562 "Depreciation and Amortization" as relating to four items of "nonrecovery property": the factory building itself, and improvements or additions made to the building in 1977, 1978, and 1979-80. For each of these items of depreciation, the "Method of figuring depreciation" that was indicated o Form 4562 was the straight line method. The $360,2 improvements made in 1982 were not included in the asse depreciated on petitioners' original 1982 return, and the were not otherwise reflected on that return. The parti have stipulated that these 1982 improvements "were neith expensed nor capitalized" on petitioners' original return.

Petitioners filed an amended return for 1982 on Septe ber 23, 1983, on which they claimed an additional depreci tion deduction in the amount of $54,044, attributable depreciation of the $360,294 improvements. On the For 4562 accompanying the amended return, petitioners liste the improvements in section B "Depreciation of recover property" as "5-year property" to be depreciated over "Recovery period" of "5 yrs."[1] Petitioners identified th "Method of figuring depreciation" used as "ACRS" and th percentage of the cost of the improvements which w depreciated as "15%". This 15-percent figure is the applic ble percentage shown in the table in section 168(b)(1) for us in the first year of a 5-year recovery period. That table fro which petitioners derived their depreciation percentage em bodies the "Prescribed method" under section 168 whic for 3-year, 5-year, 10-year, and 15-year public utility pro erty that was placed in service between 1981 and 198 "approximate[s] the benefit of using the 150-percent decli ing balance method for the early years of the recover period with a switch to the straight-line method for th remainder of the recovery period, including the use of 'half-year convention' for the year of acquisition".[2] S. Rep 97-144, at 50 (1981). On their amended return petitione also claimed, in connection with the improvements, 20-percent rehabilitation credit in the amount of $72,05 only $48,083[3] of which was used in 1982 and the remainde of which was carried over to 1983.

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[1] If petitioners had elected under sec. 168(b)(3) to use the optional straight line method depreciation, they would have had the choice of depreciating the improvements over specifie longer recovery periods.

[2] If petitioners had instead used the elective straight line method of sec. 168(b)(3) over th 5-year period shown on their return, the applicable percentage for depreciation would be 1 percent because "If the straight-line method is elected, a half-year of cost recovery is allowabl for the year the property is placed in service". S. Rept. 97-144, at 52 (1981), 1981-2 C.B. 42

[3] There is an unexplained $2 difference between this $48,083 amount which appears from th return and is stipulated to be the amount of the credit used in 1982, and the $48,081 amoun which the Commissioner claims as a deficiency.

In his notice of deficiency, the Commissioner modified in two ways the petitioners' treatment of the 1982 improvements as shown on their amended return. First, the Commissioner reduced the depreciation deduction attributable to the improvements from the $54,044 claimed to $7,206. This reduction resulted from his determination that the improvements were correctly depreciated over a "useful life of 15 years instead of [the] 5 years reported on your return". The Commissioner, in his determination, did not change petitioners' depreciation method to the straight-line method, but merely lengthened the recovery period over which the appropriate accelerated depreciation method under section 168(b) was to be used.[4]

Second, the Commissioner disallowed the rehabilitation investment credit taken with respect to the improvements "because the improvements do not qualify for the investment credit under Section 38". The sole basis that has been presented to this Court for disallowing the credit is that petitioners did not make the election to use straight line depreciation upon which section 48(g)(2)(B)(i), I.R.C. 1954, conditions entitlement to the rehabilitation investment credit. Since petitioners concede the correctness of the Commissioner's determination of the recovery period, the only issue before us is the correctness of his determination that petitioners did not make the required election and therefore are not eligible for the rehabilitation tax credit.

The improvements, and related expenditures, for which petitioners seek a tax credit were made in 1982. As effective for that year, section 46(a)(2)(F), I.R.C. 1954, allows a credit against income tax computed as a percentage of the taxpayer's "qualified rehabilitation expenditures". The credit, however, is conditioned on the expenditures coming within the definition of "qualified rehabilitation expenditure[s]" set out in section 48(g)(2), I.R.C. 1954. That definition, in section 48(g)(2)(B)(i), specifies that:

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[4] The Commissioner thus accepted petitioners' option to use an accelerated method, but found that petitioners had applied the wrong accelerated method by using the table in sec. 168(b)(1) with respect to "5-year" property. In correcting the situation, the Commissioner followed the accelerated method formula prescribed in sec. 168(b)(2) for "15-year real property". That method is embodied in tables which are drawn up by the Secretary "in accordance with use of the 175 percent declining balance method * * * switching to the method described in sec. 167(b)(1) at a time to maximize the deduction allowable under subsection (a)" and "determined on the basis of the number of months" in the first year the property is placed in service. Sec. 168(b)(2)(A). Petitioners have not contested the Commissioner's adjustment thus reducing the amount of allowable depreciation.

> (B) * * * The term "qualified rehabilitation expenditure" does not include—
>
> (i) * * * Any expenditures with respectto which an election has *not* been made under section 168(b)(3) (to use the straight-line method of depreciation). [Emphasis supplied.]

The effect of section 48(g)(2)(B) is to exclude those expenditures "with respect to which an election has not been made" from the definition of qualified expenditures, and thereby to condition the availability of the credit on the making of the election "under section 168(b)(3) (to use the straight-line method of depreciation)." Section 168(b)(3), I.R.C. 1954, describes the election therein as follows: "the taxpayer may elect * * * the applicable percentage [by which to depreciate] determined by use of the straight-line method". It is apparent from the legislative history accompanying the addition of this election condition to the definition of a "qualified rehabilitation expenditure" that "These [rehabilitation] credits are available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures". Conf. Rept. 97-215, at 221 (1981), 1981-2 C.B. 494; S. Rept. 97-144, at 72 (1981), 1981-2 C.B. 437. The language of section 48(g)(2)(B) itself, the language of its legislative history, and the fact that Congress' addition of the election condition coincided with its adoption of the Accelerated Cost Recovery System,[5] make it clear that the purpose of the election provision is to require the taxpayer to choose the benefits of either the accelerated depreciation method provided in ACRS or the rehabilitation tax credit. The taxpayer is thus to be entitled to one of these benefits, but not both, and is required to make his election in a specified manner. We hold that petitioners have failed to do so.

Since the election required to be made by section 48(g)(2)(B) is an election under section 168(b)(3), the Code provision governing the "Manner and time for making elections" under section 168 applies to the election here.

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[5] Both were enacted as part of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, 203, 237.

That provision is section 168(f)(4) and in relevant part[6] it demands that:

> (B)(i) * * * any election under this section shall be made on the taxpayer's return of the tax imposed by this chapter for the taxable year concerned.
>
> * * * * * *
>
> (C) * * * Any election under this section, once made, may be revoked only with the consent of the Secretary.

Consequently, to qualify for the credit, petitioners must have elected, in accordance with section 168(f)(4)(B),[7] to depreciate the 1982 improvements using the straight line method. In section 168(f)(4)(B)(i), Congress prescribed that the election be made "on the taxpayer's return * * * for the taxable year concerned". Petitioners are required to follow Congress' prescription in order that their election be effective. *Riley v. Commissioner*, 311 U.S. 55, 58 (1940). This, however, petitioners simply did not do.

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[6] The parties both agree that sec. 168(f)(4)(B)(ii) is not relevant to the election with respect to the improvements that are required to be made by petitioners here. That clause of subparagraph (f)(4)(B) is entitled "Special rule for qualified rehabilitated buildings" and it applies to an election with respect to the original building which has become the object of a rehabilitation effort. It was added by the Technical Corrections Act of 1982, Pub. L. 97-448, 96 Stat. 2371-2372, in order to remedy a perceived problem caused by the combination of two provisions added to the Code in 1981 in the Economic Recovery Tax Act, Pub. L. 97-34. Those two provisions are, first, sec. 168(f) and, second, sec. 48(g)(2)(B). Sec. 168(f) requires that components of section 1250 property be depreciated using the same method as is used for the building itself. It allows an exception to that rule for substantial improvements made 3 years or more after the building was placed in service. For substantial improvements, such as rehabilitation expenses, made within 3 years of the taxpayer's placing the building in service, the improvements must be depreciated using the same method as is used for the building. Under sec. 48(g)(2)(B), a credit is available for the expenses of rehabilitation improvements only if those improvements are depreciated using the optional straight line method in sec. 168(b)(3). A problem arose when these two Code sections, in combination, were applied to a taxpayer who had chosen an accelerated method of depreciating his building when he first placed it in service, and then, within the 3-year period made a rehabilitation improvement to the building. In this situation, the taxpayer would be *required* under sec. 48(g)(2)(B) to elect straight line depreciation of the improvements in order to be eligible for a rehabilitation credit *and* he would be *prohibited* under sec. 168(f) from electing straight line depreciation of the improvements because the building itself had been depreciated using an accelerated method. To remedy this problem affecting rehabilitation improvements made within the 3-year period, Congress added sec. 168(f)(4)(B)(ii). In so doing, the committees explained, it allowed the taxpayer to "elect the straight-line method for the building shell at any time within 3 years after the shell is placed in service by the taxpayer". H. Rept. 97-794, at 8; S. Rept. 97-592, at 10, 1983-1 C.B. 478. Since the election to be made in this case is an election with respect to the improvements and not an election with respect to the building shell, sec. 168(f)(4)(B)(ii) is inapplicable in this case. Here, petitioners put the building itself in service in 1973, some 9 years prior to the improvements in issue, and, beginning in 1973, used the straight line method of depreciation for the building itself as well as for the nonrehabilitation improvements made in 1977, 1978, and 1979-80. The agreement of the parties herein that sec. 168(f)(4)(B)(ii) is inapplicable is consistent with and undoubtedly reflects the foregoing analysis.

[7] The parties also discuss, on brief, the requirements of Proposed Reg. sec. 1.168-5(e)(2) and respondent also notes, in his reply brief, the requirements of Temporary Reg. sec. 5c.0, T.D. 7793, 46 Fed. Reg. 51907 (Oct. 23, 1981), 1981-2 C.B. 62. Given the conclusion reached herein based on the requirements of the Code itself, we need not consider the applicability of either of these regulations, both of which contain more stringent requirements for the time and manner of making elections than does the naked language of the Code itself. It is clear that a contrary result would not be mandated by these regulations.

Nowhere on either their 1982 original or their 1982 amended return,[8] or on any attachment to those returns, did petitioners in any way indicate that they chose to use the straight line method[9] which would make available to them the rehabilitation credit claimed. Instead, in their original return, they did not report the rehabilitation expenses at all,[10] and in their amended return, they both depreciated their rehabilitation expenses using the accelerated method in section 168(b)(1) and claimed a rehabilitation credit with respect to those expenses. In so doing, they failed to meet even the most minimal requirements for the making of a valid election. A valid election will not be found to be made unless the taxpayer "inform[s] the Commissioner that an election has been made", *Knight-Ridder Newspapers v. United States*, 743 F.2d 781 (11th Cir. 1984); "evidence[s] an affirmative intent * * * to make the required election and be bound thereby", *Atlantic Veneer Corp. v. Commissioner*, 85 T.C. 1075, 1082-1083 (1985); and "effectively commit[s] itself to employ such [elected] method," *Hewlett-Packard Co. v. Commissioner*, 67 T.C. 736, 743 (1977). Petitioners' election, because it is governed by section 168(f)(4)(C), presents perhaps the strongest case for requiring that the election be made with unquestionable clarity since the election, "once made, may be revoked only with the consent of the Secretary". Sec. 168(f)(4)(C).

To be effective, a taxpayer's election must indicate both an "unequivocal agreement to elect and comply with the terms of [the elected] section", *Young v. Commissioner*, 83 T.C. 831, 839 (1984), affd. 783 F.2d 1201 (5th Cir. 1986), and an "unequivocal agreement to take the benefits and burdens of [the elected] section," *Valdes v. Commissioner*, 60 T.C. 910, 914 (1973). In this case, petitioners' election must do even more. It must indicate that they chose to take the benefits and burdens of the rehabilitation credit, and it must indicate that they chose to forgo the benefits and burdens of the accelerated method of depreciation allowed under section 168(b). Petitioners' returns do nothing of the sort.

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[8] We need not decide whether the language of sec. 168(f)(4)(B) requiring an election to be made "on the taxpayer's return" is properly read to disallow an election in an amended return filed after the date for filing a return. Even considering petitioners' untimely filed amended return, we find that no election to use the straight line method has been made.

[9] Petitioners' description on their amended return of their "Method of figuring depreciation" as "ACRS" is, by itself, ambiguous. The Accelerated Cost Recovery System includes both an accelerated method of depreciation and an optional straight line method of depreciation for both personal and real property. It was petitioners' depreciation of the improvements by 15 percent of their cost in the first year of recovery that makes it clear that they are using an accelerated method of depreciation. If petitioners were using the straight line method they would have depreciated the improvements by only 10 percent in that year. See note 2 *supra*.

[10] Petitioners concede, as indeed they must, that they did not make the election to use the alternative straight line method of depreciation on their original 1982 return.

Their original return does not reflect the rehabilitation expenses at all; the parties have stipulated that the election was not made on that return. Petitioners' amended return reflects both (1) their use of the accelerated method of depreciation embodied in section 168(b)(1), not the required straight line method, and (2) their claim of a rehabilitation credit with respect to the improvements. The Code provisions allowing for a rehabilitation credit require that the taxpayers choose one of those favorable tax treatments or the other. Nonetheless, petitioners depreciated the improvements on their return using the accelerated method, and then still claimed the credit. Their return reveals, at best, only ambiguous intentions. It certainly does not indicate that they meant to give up the benefits of accelerated depreciation in order to qualify for the credit. Consequently, we find that the election not to use the accelerated method of depreciation, which election would qualify them for the rehabilitation credit, was not made on that return.

Petitioners contend that they "should be allowed" to elect the straight line method of depreciation "on an amended return filed within the statute of limitations". We have found, on the record in this case, that they did not so elect straight line depreciation on their amended return or on any other return. In these circumstances we refuse to address the hypothetical question whether petitioners "should be allowed" to make the required election on an amended return filed after the time for filing a return but before the statute of limitations for the tax year has run. Only if petitioners had made such an election on such a return would we be faced with that question. As it is, petitioners have made no election under section 168(b)(3) and, as a result, are ineligible for the credit in section 38 claimed on the basis of rehabilitation expenditures.

In *Estate of Rosenberg v. Commissioner*, 86 T.C. 980, 986-987, 988-989 (1986), we recently had occasion to express exasperation at the incredible complexity of certain provisions of the Internal Revenue Code. The present case, involving entirely different provisions of the Code, is but a further example of its complexity.[11] What we said in *Foxman v. Commissioner*, 41 T.C. 535, 551 n. 9 (1964), affd. 352 F.2d 466 (3d Cir. 1965), in respect of still other provisions of the Code is equally applicable here:

> The distressingly complex * * * nature of the provisions * * * presents a formidable obstacle to [their] comprehension * * * without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field.

Adapting what we said further in *Foxman*,

> If there should be any lingering doubt on this matter one has only to reread [the provisions in their] * * * entirety * * * and give an honest answer to the question whether [they are] * * * reasonably comprehensible to the average lawyer or even to the average tax expert who has not given special attention and extended study to the tax problems [presented by these provisions].

Bearing in mind that the Code is of nationwide application affecting tens of millions of taxpayers, it is difficult to understand why it is so constructed that so many of its provisions can confidently be dealt with by only a comparatively small number of highly skilled or trained persons who have expended a disproportionate amount of time and effort to master the mysteries of the particular intricate provisions under consideration. Surely, there must be a better way of constructing a fair and workable system of taxation.

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[11] Cf. also *Bolton v. Commissioner*, 77 T.C. 104, 109 (1981), affd. 694 F.2d 556 (9th Cir. 1982); *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510, 516 (1975), affd. 578 F.2d 827 (9th Cir. 1978); *Frankfort v. Commissioner*, 52 T.C. 163, 168 (1969); *Foxman v. Commissioner*, 41 T.C. 535, 550, 551 n. 9 (1964), affd. 352 F.2d 466 (3d Cir. 1965); *Van Products, Inc. v. Commissioner*, 40 T.C. 1018, 1028 (1963); *Lewis v. Commissioner*, 35 T.C. 71, 76 (1960).

Decision will be entered under Rule 155.

RUSSELL R. MEARKLE AND VIRGINIA R. MEARKLE, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28428-84. Filed August 25, 1986.

After our decision in *Scott v. Commissioner*, 84 T.C. 683 (1985), in which the portion of the proposed regulation relied on by respondent here was determined to be inconsistent with the statute, respondent moved to dismiss and enter decision that no deficiency exists. We granted the motion. Petitioners moved for litigation costs under sec. 7430, I.R.C. 1954. *Held*, respondent was not unreasonable in continuing to advocate the position embodied in a proposed regulation until, and for a reasonable time after, the portion of the regulation embodying the position was determined to be inconsistent with the statute.

Robert A. Clemente,[1] for the petitioners.
Robert Fernandez, for the respondent.

OPINION

PARR, *Judge*: Respondent determined a deficiency in petitioners' 1981 Federal income tax in the amount of $149. The issue for decision is whether an award of litigation costs under section 7430[2] is appropriate here.

Respondent determined the deficiency herein based on section 1.280A-2(i)(2)(ii), Proposed Income Tax Regs.,[3] which we held was inconsistent with the statute in *Scott v.*

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[1] After the motion decided herein was filed, Mr. Clemente replaced as counsel for petitioners J. William Dantzler. Although it is Mr. Dantzler's fee that is at issue, and his motion which requests those fees, we refer above to petitioners' present counsel of record.

[2] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] In 1983, the Commissioner revised the proposed regulations under sec. 280A. 48 Fed. Reg. 33325 (July 21, 1983). The revised proposed regulations rearrange the provisions here at issue but make no significant changes in them. The provision in question is now sec. 1.280A-2(i)(2)(iii) of the proposed regulations.

Commissioner, 84 T.C. 683 (1985). That regulation viewed the gross income from a business conducted out of a home office as net of certain deductions. This effectively lowered the ceiling on home office expense deductibility.

The 90-day appeal period in *Scott* expired on July 14, 1985. On October 16, 1985, respondent offered to concede this case by forwarding his standard proposed decision document to petitioners. Petitioners answered by letter dated February 4, 1986, proposing an alternative decision document which contained an acknowledgment by respondent that he was conceding the case because he did not want to relitigate the *Scott* issue on these facts. On February 5, 1986, respondent telephoned petitioners' counsel to say the counter-proposed decision document was unacceptable.

The petition in this case was filed August 9, 1984. The case was called at the commencement of this Court's February 10, 1986, calendar in New York City. At that time, respondent moved to dismiss the case and have the Court enter a decision that there is no deficiency in petitioners' 1981 income tax. Petitioners opposed, seeking a trial and thus a decision which could serve as precedent for future similar cases arising in this factual context. We granted respondent's motion to dismiss, and entered a decision in favor of petitioner.[4]

On February 19, 1986, the decision in this case was entered. On March 21, 1986, in compliance with Rule 231(a), petitioners moved for litigation costs. On April 4, 1986, we vacated our decision in this case to allow consideration of petitioners' motion[5] and ordered a response. On May 20, 1986, respondent filed a notice of objection.

Section 7430[6] provides, in pertinent part, that if a taxpayer who has substantially prevailed with respect to either the amount in controversy or the most significant issue or set of issues presented establishes that the position of the United States in the civil proceeding was unreasonable, that the taxpayer may be awarded a judgment for reasonable litigation costs incurred in the proceeding. Petitioners have the burden of establishing unreasonableness. See *DeVenney v. Commissioner*, 85 T.C. 927, 928-930 (1985).

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[4] See *LTV Corp. v. Commissioner*, 64 T.C. 589 (1975); compare *McGowan v. Commissioner*, 67 T.C. 599 (1976).

[5] Sec. 7430(e) provides that an order granting or denying an award for reasonable litigation costs shall be incorporated as part of the decision and shall be subject to appeal in the same manner as the decision. We therefore vacated our decision of Feb. 26, 1986, so that we could incorporate such order.

[6] SEC. 7430. AWARDING OF COURT COSTS AND CERTAIN FEES.

(a) IN GENERAL.—In the case of any civil proceeding which is—

(1) brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, and

(2) brought in a court of the United States (including the Tax Court and the United States Claims Court),

Although respondent prevailed in his motion to dismiss this case, we entered a decision that there was no deficiency. Petitioners therefore prevailed with respect to the only substantive issue in the case.[7] Moreover, respondent concedes that petitioners have exhausted their administrative remedies, as required by section 7430(b)(2). We find that they have. At issue is whether respondent's position in this proceeding was unreasonable.

In this case, petitioners do not urge us to judge respondent's pre-petition conduct for reasonableness. We therefore do not revisit here the propriety of examining pre-petition

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the prevailing party may be awarded a judgment for reasonable litigation costs incurred in such proceeding.

* * * * * *

(c) DEFINITIONS.—For purposes of this section—

(1) REASONABLE LITIGATION COSTS.—

(A) IN GENERAL.—The term "reasonable litigation costs" includes—

(i) reasonable court costs,

(ii) the reasonable expenses of expert witnesses in connection with the civil proceeding,

(iii) the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and

(iv) reasonable fees paid or incurred for the services of attorneys in connection with the civil proceeding.

(B) ATTORNEY'S FEES.—In the case of any proceeding in the Tax Court, fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court shall be treated as fees for the services of an attorney.

(2) PREVAILING PARTY.—

(A) IN GENERAL.—The term "prevailing party" means any party to any proceeding described in subsection (a) (other than the United States or any creditor of the taxpayer involved) which—

(i) establishes that the position of the United States in the civil proceeding was unreasonable, and

(ii)(I) has substantially prevailed with respect to the amount in controversy, or

(II) has substantially prevailed with respect to the most significant issue or set of issues presented.

(B) DETERMINATION AS TO PREVAILING PARTY.—Any determination under subparagraph (A) as to whether a party is a prevailing party shall be made—

(i) by the court, or

(ii) by agreement of the parties.

[7] That respondent moved to dismiss did not prevent a fee award in *Linn v. Chivatero*, 790 F.2d 1270 (5th Cir. 1986). Likewise, we will not allow it to suffice here to prevent an award.

conduct. But cf. *Powell v. Commissioner*, 791 F.2d 385 (5th Cir. 1986), revg. and remanding T.C. Memo. 1985-27. The parties have filed no affidavits or agreed statement of facts pursuant to Rule 232(b) on the issue of reasonableness. We therefore must decide the motion on the basis of the pleadings. The gravamen of petitioners' allegation of respondent's unreasonableness is as follows: Petitioners claimed a deduction for use of an office in the home, which deduction did not exceed petitioners' "gross income derived from such use," a limitation imposed by section 280A. For this purpose, petitioners defined gross income as "gross receipts less cost of goods sold, plus bonuses." Petitioners contend that respondent unreasonably disallowed the deduction, construing the phrase "gross income derived from such use" to be net of expenditures required for the activity but not allocable to the use of the unit itself (such as expenditures for supplies and compensation paid to other persons). Petitioners state that such a definition is at odds with the plain words of the statute, finds no support in its legislative history, and is unreasonable, and that this Court has so held in *Scott v. Commissioner, supra.*

Respondent counters that he relied on section 1.280A-2(i)(2)(ii), Proposed Income Tax Regs., that reliance on the proposed regulation was reasonable, and that conceding the case 3 months after we declared the relevant portion of the proposed regulation to be inconsistent with the statute was also reasonable. We agree with respondent.

Respondent frames his case in terms of reliance on a proposed regulation. Our task, therefore, is to determine whether such reliance was reasonable. Because we think reliance on a final regulation would be reasonable and because we think proposed and final regulations should be treated alike for purposes of section 7430, we deny petitioners' motion.

Were a final regulation at issue here, the Commissioner would, except in the most unusual of circumstances, be insulated from a section 7430 award for at least three reasons. First, although a final regulation we strike down is, by definition, unreasonable (see *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981)), it also has the status of law at least until invalidated by a court. See

Boske v. Comingore, 177 U.S. 459 (1900). A taxpayer may rely on a regulation until altered by the Commissioner. See *Commercial Shearing & Stamping Co. v. Commissioner*, 36 T.C. 433 (1961). We think the Commissioner should be able to rely on it as well.

Second, the Commissioner is legally required to enforce the revenue laws. See sec. 7801; Statement of Procedural Rules, sec. 601.101. The regulations contain the details of those laws which Congress has asked the Treasury to enforce and are therefore part of those laws. See *Boske v. Comingore, supra*. To make an award under section 7430 for what the Commissioner appears required to do under section 7801, i.e., enforce the revenue laws, would put those statutes at odds with each other. We will refrain from interpreting one statute in derogation of another. Cf. *United States v. United Continental Tuna Corp.*, 425 U.S. 164, 168-169 (1976).

Finally, administrative havoc would result if the Commissioner had to weigh the threat of a section 7430 award where the regulations clearly and unequivocally support his position. Congress intended that respondent would consider section 7430 as a litigating hazard where he contemplated taking a position arguably beyond the pale of reason. See H. Rept. 97-404, at 11 (1981). As discussed below, however, Congress could not have intended to grind to a halt the operations of the Internal Revenue Service by forcing respondent to second-guess the policy decisions embodied in the regulations.

Having stated all this with respect to final regulations, we now ask whether a different result should obtain because the regulation relied on here was only in the proposed stage. We begin the analysis by acknowledging that although final "regulations command our respect" (*Commissioner v. Portland Cement Co. of Utah*, 450 U.S. at 169), "proposed regulations carry no more weight than a position advanced on brief by the respondent." *Freesen v. Commissioner*, 84 T.C. 920, 939 (1985), revd. on other grounds 798 F.2d 195 (7th Cir. 1986), quoting *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970).

Significantly, we have adhered to the latter proposition only when discussing the degree of deference this Court should accord the position embodied in a proposed regulation. See *Freesen v. Commissioner, supra*; *Tamarisk Country Club v. Commissioner*, 84 T.C. 756, 761 n. 8 (1985); *Scott v. Commissioner, supra*; *Miller v. Commissioner*, 70 T.C. 448, 460 (1978); *F.W. Woolworth Co. v. Commissioner, supra.*[8] Assessing the section 7430 reasonableness of respondent's reliance on a proposed regulation is a different inquiry. We think that for that latter purpose, proposed regulations should be treated like final regulations. Put another away, although *we* need not accord the same deference to proposed as to final regulations, we cannot hold *respondent* unreasonable for adhering to proposed regulations as he would adhere to final regulations, at least until they are judicially disapproved.[9]

Moreover, an analysis of the legislative history of section 7430 reveals that the purposes behind the statute would not be materially furthered by awards in situations such as the one before us. Section 7430 was enacted, in part, to "deter abusive actions or overreaching by the Internal Revenue Service." H. Rept. 97-404, at 11 (1981). We do not believe Congress sought to deter respondent from relying upon a regulation duly promulgated or proposed. Section 7430 aims instead at deterring specific abusive actions by respondent's employees, against specific taxpayers, in specific cases. The legislative history supports this conclusion:

> The committee intends that the determination by the court on [reasonableness] is to be made *on the basis of the facts* and legal precedents *relating to the case as revealed in the record*. Other factors the committee believes might be taken into account in making this determination include, (1) whether the government used the costs and expenses of litigation against its position *to extract concessions from the taxpayer* that were not justified *under the circumstances of the case*, (2) whether the government pursued the litigation *against the taxpayer for purposes of harassment or embarrassment*, or out of political motivation, and (3)

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[8] See also *Engle v. Commissioner*, 76 T.C. 915, 943 n. 8 (1981) (Fay, J., dissenting), revd. 677 F.2d 594 (7th Cir. 1982), affd. 464 U.S. 206 (1984); *Glass v. Commissioner*, 76 T.C. 949, 961 n. 3 (1981) (Fay, J., dissenting). But see *Commissioner v. Engle*, 464 U.S. 206, 228 (1984) (Blackmun, J., dissenting) (applying rule of deference to position embodied in proposed regulations).

[9] Although we need not decide the issue, it is possible that the Commissioner may reasonably rely on regulations until long after they are struck down, depending on which court has struck down the regulation, whether any others have upheld it, where the litigation is taking place, and the force behind the Commissioner's argument in favor of the regulation's continuing validity.

> such other factors as the court finds relevant. * * * [H. Rept. 97-404 at 12 (1981); emphasis added.]

We do not think generalized interpretations by Treasury Department policy makers, affecting classes of anonymous taxpayers, are within the intended ambit of the statute.

For these reasons, if respondent relies on a proposed regulation, such reliance will bar the imposition of costs under section 7430.

We are thus brought to the issue of whether respondent's position was unreasonable after we declared the proposed regulation to be inconsistent with the statute.[10] Respondent conceded the case within 3 months after the appeal period ran on the case in which we held his position was in error. This is reasonable.[11]

We hold that advocacy of a position embodied in a proposed or final regulation is reasonable under section 7430 until the regulation is overturned by a court, and for a reasonable period of time thereafter. Falling within this rule, the Commissioner here has insulated himself from an award under section 7430.

An appropriate order and decision will be entered.

ROBERT S. GROETZINGER AND BEVERLY L. GROETZINGER, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 562-82. Filed August 26, 1986.

Ps, husband and wife, were employed abroad under a joint employment contract, which provided a stock option for petitioner-husband alone. *Held*: Ps, who were free to structure the provisions of their joint employment contract as they wished, and who abided by the contract as they made it, must accept the tax consequences of their structural choice. *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). Therefore, Ps may not allocate any of the gain from petitioner-husband's 1978 disposition of the stock to petitioner-wife for the purpose of computing her foreign earned income exclusion under sec. 911, I.R.C. 1954. *Held, further*, Ps may attribute petitioner-husband's stock option proceeds to their 1977 gross income under the attribution rule of sec. 911(c)(2) for the limited purpose of computing the foreign earned income exclusion for 1977 under sec. 911(a)(l) and (c)(l)(B).

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[10] In this regard, we note the congressional admonition that "the pursuit of litigation by the government to establish a conflict among the United States Circuit Courts of Appeals would not be unreasonable." H. Rept. 97-404, at 12 (1981). We are also mindful that under the predecessor to sec. 7430, the Equal Access to Justice Act, 28 U.S.C. sec. 2412 (1982), it is not required of "the government to establish that its decision to litigate was based on a substantial probability of prevailing." H. Rept. 96-1418, at 11 (1980). However, we leave for another day the decision whether costs and fees should be awarded in a case in which respondent continues to advocate a position contained in a regulation previously judicially invalidated or disapproved. See *supra* note 9.

[11] See *Spirtis v. Commissioner*, T.C. Memo. 1985-44 (4½ months between filing of petition and concession of issue not unreasonable).

Robert S. Groetzinger, pro se.
Mark S. Priver, for the respondent.

OPINION

NIMS, *Judge*: Respondent determined deficiencies of $297 and $28,276.23 in petitioners' joint Federal income tax for 1977 and 1978, respectively. After concessions, two issues remain: (l) Whether petitioners, husband and wife, may disavow the form of the stock option provision within their employment contract so as to allocate the stock option proceeds between themselves for purposes of computing their section 911 foreign earned income exclusions;[1] and (2) whether petitioners may attribute any income from the 1978 disposition of the employee stock option to 1977 by virtue of the attribution rule of section 911(c)(2) (now section 911(b)(2)(B)).

This case has been submitted fully stipulated. The evidence consists of a stipulation of facts with attached exhibits which is incorporated herein by this reference.

Robert S. Groetzinger and Beverly Groetzinger (hereinafter referred to as petitioners, collectively, or Robert and Beverly, individually) were married and residents of Fribourg, Switzerland, at the time the petition was filed in this case, and were bona fide residents of a foreign country at all times during the taxable years in issue, 1977 and

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[1] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

1978. Petitioners were employees of American Telecommunications Corp. (ATC), a California corporation, during the tax years in question pursuant to a written, joint employment contract between petitioners and ATC. The parties executed the agreement on November 1, 1976. The terms of the agreement are set forth in an 8-paragraph instrument.

Paragraph 1 of the instrument[2] essentially provides for the employment of Robert and Beverly with American Telecommunications S.A. (ATSA), a subsidiary of ATC in Fribourg, Switzerland. Paragraph 1 also specifies the employment title and salary of Robert and Beverly. Robert was to be employed as President of ATSA at a annual salary of $16,000 and Beverly as an administrative secretary at an annual salary of $8,000.

Paragraph 2 sets forth the terms of the employee stock option.[3] This paragraph refers to "R.S. GROETZINGER" as the optionee. The paragraph describes the contingencies, the quantities of shares, and the dates upon which Robert could exercise the option. Paragraph 2 makes no explicit or implicit reference to Beverly.

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[2] Par. 1 of the employment contract provides in relevant part:

"Mr. R.S. GROETZINGER will be employed as President of ATC's subsidiary company in Fribourg Switzerland, AMERICAN TELECOMMUNICATIONS S.A. ('ATSA') at a salary of $16,000 per year. BEVERLY L. GROETZINGER, his wife, will be employed as administrative secretary of ATSA at a salary of $8,000 per year. During the period of employment of Mr. GROETZINGER by ATSA, MANAGEMENT AND FINANCE S.A., of Fribourg Switzerland ('MAFSA') will be paid a consulting fee of $6,000 per year. * * *"

[3] Par. 2 of the employment contract provides:

"Subject to ATC Board of Directors' approval and further subject to and contingent upon the validity and operability under applicable laws and regulations, it is intended that Mr. R.S. GROETZINGER will receive a stock option in two parts.

"A. 8,000 shares of a normal ATC stock option based on a plan to be initially presented at the next ATC board meeting. This plan will allow R.S. GROETZINGER to exercise 20% of the shares during each year of his employment for five years at the market price prevailing at the time the option is initially granted by the ATC board.

"B. Up to 10,000 additional shares on terms similar to the normal ATC stock option will be made available at market price at the date of the initial grant by the ATC board on the following basis if Mr. GROETZINGER is then still employed by ATSA: If on May 1, 1979, the cumulative sales of ATSA will have been $4,576,981 or more, Mr. GROETZINGER will be able to exercise an option for 687 shares. If on May 1, 1980, the cumulative sales of ATSA will have been $9,607,448 or more, Mr. GROETZINGER will be able to exercise an option for 1,226 additional shares. If, for any reason, the 687 shares scheduled for the previous year were not exercised, he may then also exercise those shares. If on May 1, 1981, the cumulative sales of ATSA will have been $18,578,929 or more, Mr. GROETZINGER will be able then to exercise an option for 2,187 additional shares. In addition, he may exercise his option for the shares which he would have been eligible for at May 1, 1979, and May 1, 1980, if he did not exercise those options at that time. If on May 1, 1982, the cumulative sales of ATSA will have been $34,578,929 or more, Mr. GROETZINGER will be able to exercise an option for 3,900 additional shares. In addition, he may then exercise his option for the shares which he would have been eligible for during the three previous years. Also in addition, on May 1, 1982, if the cumulative sales are greater than that figure ($34,578,929), he may exercise an option for one additional share for each $4,322.37 of sales over that total to a maximum of 2,000 additional shares."

Paragraphs 3 through 8 set forth further incidents of employment.[4] In each instance, these remaining paragraphs refer to petitioners collectively. Paragraph 8 provides in conclusion that the agreement as written would be construed and performance determined under California law and could not be amended except by an instrument executed by all of the parties.

On January 19, 1977, the board of directors of ATC formally granted to Robert a stock option on ATC stock pursuant to paragraph 2 of the employment contract.

Petitioners filed a joint individual income tax return for the calendar year 1977. On this return they reported gross income of $39,486.83. For purposes of the foreign earned income exclusion, Robert reported $20,009.60 and Beverly reported $10,004.80 of foreign earned income.

During 1978 Robert exercised his option on 10,000 shares of ATC stock.[5] On December 1, 1978, ATC transferred the 10,000 shares to Robert, who paid $40,000 for the lot. Robert sold the 10,000 ATC shares within the month for the sum of $235,000. This sum was deposited in petitioners' joint bank account on December 11, 1978. The gain amounted to $195,000.

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[4] Pars. 3 through 8 of the employment contract provide in relevant part:

3. Mr. and Mrs. GROETZINGER will be immediately eligible for health insurance under ATC's normal Blue Cross plan. * * *

4. The employees have agreed to move their residence from London to Switzerland as soon as practicable and to there establish ATC's principal European operating headquarters. * * *

5. Special Overseas Benefit — Commencing in 1978 and each year thereafter in which both Mr. and Mrs. GROETZINGER are employed by ATSA, ATC agrees to reimburse them for the cost of economy airfare from Europe to the U.S.A. for the purpose of annual home leave. * * *

6(a) Unless sooner terminated for cause by either party, or except as provided in (b) below, this agreement will be effective for three (3) years commencing on November 1, 1976.

(b) Either party may terminate this Agreement at any time upon one (1) year's written notice. It is expressly agreed by R. S. GROETZINGER and by B. L. GROETZINGER that they have accepted this provision for termination by ATC on one year's notice * * *

7. It is contemplated and agreed to by the parties that this Agreement may be assigned by ATC to ATSA at some time in the future, at ATC's option.

8. Miscellaneous

A. This Agreement will be construed and performance determined in accordance with the laws of the State of California, U.S.A.

B. This Agreement constitutes the entire agreement related to the employment of R.S. GROETZINGER and B.L. GROETZINGER by ATC and/or by ATSA and shall not be varied, amended or supplemented except by an instrument in writing executed by all the parties * * *

[5] The record does not reveal how Robert in 1978 could exercise the option on 10,000 shares of ATC stock within the terms of the stock option plan as provided in par. 2 of the employment contract.

Petitioners filed a joint individual income tax return for the calendar year 1978. On this return they reported gross income of $146,850. Robert reported $125,594 in foreign earned income, which consisted of $97,500, or half of the gain, from the disposition of the employee stock option and $28,094 in salary. Beverly reported $10,747 in foreign earned income, which consisted of her ATSA salary alone. Under section 911, Robert and Beverly excluded $15,000 and $10,747, respectively, of their foreign earned income. On Form 3921 of petitioners' 1978 return, they described the option exercised as a restricted stock option within the meaning of section 424(b) and Robert as the person to whom the optionor ATC transferred the stock. Petitioners consistently described in their returns Robert's occupation as businessman and Beverly's as corporate secretary.

In 1979 and 1980, petitioners filed two amendments to their 1977 tax return and one amendment to their 1978 return. Essentially, petitioners' amendments to their 1977 and 1978 tax returns reallocated the gain from the 1978 disposition of ATC stock first, between petitioners' taxable years 1977 and 1978 and second, between Robert and Beverly for 1978 for purposes of computing their foreign earned income exclusions.

Issue 1

The first issue for decision is whether the proceeds from the stock option, which ATC explicitly granted to Robert, are divisible between Robert and Beverly for purposes of the foreign earned income exclusion provided in section 911. The resolution of this issue turns on whether petitioners may disavow the form of the employment contract pursuant to which the stock option was granted on the theory that the instrument did not represent the substance of the agreement.

Section 911,[6] for the tax years in issue, permits an individual citizen of the United States who establishes either bona fide residency in a foreign country or physical presence in such country for 17 months during a consecutive 18-month period to exclude certain earned income from foreign sources during the qualifying period. For 1978,

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[6] For 1977 sec. 911 provided in relevant part:

SEC. 911(a). GENERAL RULE.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

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(1) BONA FIDE RESIDENT OF FOREIGN COUNTRY.—In the case of an individual citizen of the United States who establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such uninterrupted period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

(2) PRESENCE IN FOREIGN COUNTRY FOR 17 MONTHS.—In the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such 18-month period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

* * * * * * *

(b) DEFINITION OF EARNED INCOME.—For purposes of this section, the term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. * * *

(c) SPECIAL RULES.—For purposes of computing the amount excludable under subsection (a), the following rules shall apply:

(1) LIMITATIONS ON AMOUNT OF EXCLUSION.—The amount excluded from the gross income of an individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of—

(A) except as provided in subparagraph (B), $20,000 in the case of an individual who qualifies under subsection (a), or

(B) $25,000 in the case of an individual who qualifies under subsection (a)(1), but only with respect to that portion of such taxable year occurring after such individual has been a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years.

(2) ATTRIBUTION TO YEAR IN WHICH SERVICES ARE PERFORMED.—For purposes of applying paragraph (1), amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed.

(3) TREATMENT OF COMMUNITY INCOME.—In applying paragraph (1) with respect to amounts received for services performed by a husband or wife which are community income under community property laws applicable to such income, the aggregate amount excludable under subsection (a) from the gross income of such husband and wife shall equal the amount which would be excludable if such amounts did not constitute such community income.

Congress revised much of sec. 911 for tax years beginning in 1978 under the Tax Treatment Extension Act of 1977, Pub. L. 95-615, sec. 202, 92 Stat. 3098 (act). Under the act's transition rule, however, taxpayers could elect for 1978 to apply sec. 911 as it existed for 1977, subject to a $15,000 limitation. Pub. L. 95-615, sec. 209, 92 Stat. 3109.

Congress initially enacted the $15,000 limitation under sec. 911(c)(1) effective for tax years beginning in 1976. Tax Reform Act of 1976, Pub. L. 94-455, sec. 1011(a), 90 Stat. 1610. Under subsequent amendments, however, Congress postponed the effective date of the $15,000 limitation until tax years beginning in 1978. See Tax Reduction and Simplification Act of 1977, Pub. L. 95-30, sec. 302, 91 Stat. 152; Tax Treatment Extension Act of 1977, Pub. L. 95-615, sec. 4(a), 92 Stat. 3097.

qualified taxpayers could elect to exclude a maximum of $15,000 for a complete tax year of foreign residence. When qualifying taxpayers are husband and wife, and both reside abroad and earn income abroad, separate ceilings apply to their earnings attributable to the services of each, even though the income is community income. Sec. 911(c)(3).

On brief, petitioners argue that for 1978, Beverly is entitled to the maximum exclusion under section 911(c)(l). The argument is predicated on their assertion that although in form the gain from the ATC stock disposition is allocable to Robert, alone, in substance the gain is allocable to both Beverly and Robert. Thus, under such allocation, Beverly's foreign earned income is sufficiently high to allow for the maximum exclusion.

In arguing substance over form, petitioners address the economic reality of the employment agreement and the intention of the parties to the agreement. Petitioners contend that in economic reality the sales-related contingencies regarding the rights to exercise the stock option were achieved only by the services of both Beverly and Robert. According to petitioners on brief, "[Robert] would never have received *his* share of the proceeds without *her* participation." (Emphasis of petitioners.) They assert that the deposit of the proceeds in their joint bank account is objective evidence that in economic reality both received the income. Petitioners also contend that the parties to the agreement intended the stock option to apply to both Robert and Beverly. Petitioners explain that "the stock option was issued only in the name of [Robert] solely for reasons of administrative facility and simplicity."

On brief, respondent makes two arguments against any allocation of gains to Beverly.[7] First, he contends that "it would defy reason" to believe the parties intended anything other than the form in which the agreement was cast because its terms are "so clearly and unmistakably described." Second, respondent argues that the stock option involved herein constitutes a section 424 restricted stock option, and to permit the transfer of ATC shares to anyone other than Robert would contradict the restrictive nature and purpose of section 424.

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[7] Respondent does not dispute that the entire gain from the disposition of ATC stock constitutes "earned income" within the meaning of sec. 911(b).

We agree with respondent's determination, although with regard to his first contention we would be reluctant to bind petitioners to the form of their agreement solely on the ground that the form is clearly described. See *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939); *Landa v. Commissioner*, 206 F.2d 431, 432 (D.C. Cir. 1953), revg. a Memorandum Opinion of this Court; *Ciaio v. Commissioner*, 47 T.C. 447, 457 (1967). Before proceeding with our reasons for deciding this issue for respondent, we pause to observe that respondent's second contention is clearly erroneous because the stock option involved herein cannot constitute a section 424 stock option by definition. According to sections 424(b) and 424(c)(3), a statutory "restricted stock option" must be granted before 1964, or later if pursuant to a binding contract made before 1964 or a written plan adopted and approved before 1964. By contrast, ATC granted Robert the stock option involved herein on January 19, 1977, pursuant to a November 1976, employment contract.

The Commissioner's determinations, however, are presumptively correct, and petitioners bear the burden of disproving his adjustments. Rule 142(a). In cases such as the one sub judice, where the taxpayer seeks to avoid the form of his own agreement, a higher level of proof, known as the "strong proof standard," often is required in order for him to carry his burden. See *Coleman v. Commissioner*, 87 T.C. 178 (1986); *Major v. Commissioner*, 76 T.C. 239, 247 (1981); *Lucas v. Commissioner*, 58 T.C. 1022, 1032 (1972).[8] We find it unnecessary to determine whether this higher standard of proof is applicable to this case, for after a careful survey of the facts before us we are convinced that the petitioner has failed to disprove by a preponderance of evidence the Commissioner's determinations.

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[8] Most of the "strong proof standard" cases involve potentially conflicting claims among taxpayers, including disputes over partial allocations of sale prices to covenants not to compete. See *Major v. Commissioner*, 76 T.C. 239, 246 (1981); *Lazisky v. Commissioner*, 72 T.C. 495, 500-502 (1979), affd. sub nom. *Magnolia Surf, Inc. v. Commissioner*, 636 F.2d 11 (1st Cir. 1980). But see *Coleman v. Commissioner*, 87 T.C. 178 (1986); *Mittleman v. Commissioner*, 56 T.C. 171, 175 (1971), affd. per curiam 464 F.2d 1393 (3d Cir. 1972).

Under the doctrine of substance over form, the objective economic realities, rather than the particular form in which the agreement was cast, govern the tax consequences of the agreement. *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978); *Gregory v. Helvering*, 293 U.S. 465 (1935). Under certain circumstances, a taxpayer may be entitled to argue substance over form in a transaction (*Helvering v. F. & R. Lazarus & Co., supra*; *Ciaio v. Commissioner, supra* at 457), although petitioner must provide objective evidence that the substance of the transaction was in accord with the position argued by petitioner rather than the form set forth by all the relevant documents. *Gulf Oil Co v. Commissioner*, 86 T.C. 937 (1986); *Yamamoto v. Commissioner*, 73 T.C. 946, 954 (1980), affd. without published opinion 672 F.2d 924 (9th Cir. 1982). Moreover, it is axiomatic that:

> while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not. * * * [*Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).[9]

We are convinced that the rule of *National Alfalfa* accurately addresses the situation presented herein. ATC and petitioners were free to structure the employment agreement, including the stock option provision, to their tax advantage. The record clearly establishes, and the petitioners do not dispute, that the employment agreement in form provided that ATC would grant the incentive stock option to Robert, alone. Under paragraph 2 of the agreement, the parties explicitly provided that Robert, rather than both Robert and Beverly, would be entitled to the stock option. The omission of Beverly's name in paragraph 2 is particularly obvious in the context of each of the remaining paragraphs, which refer to petitioners, collectively. In addition, the parties stressed in paragraph 8 of their instrument that the instrument represented the final embodiment of the agreement. In ascertaining the deliberateness of this form we look to the acts of the parties and the documentation surrounding the agreement unless we are given evidence to the contrary. *Yamamoto v. Commissioner, supra* at 954. The objective acts and documentation indicate the parties subsequently abided by the agreement as they made it. Both petitioners and respondent agree that ATC formally granted the option to Robert alone pursuant to the agreement and that Robert himself exercised this option. In addition, petitioners document in their 1978 return that ATC transferred the shares to Robert in his name, alone.

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[9] See *Treister v. Commissioner*, T.C. Memo. 1986-53.

The petitioners understandingly elected to structure the stock option in the form of compensation for Robert, alone, and abided by the agreement as they made it. Following the principle of *National Alfalfa*, we find that petitioners must accept the tax consequences of their structural choice.

We reject petitioners' argument that the substance of the agreement, including the economic realities and underlying intent, differs from its form. In applying the substance-over-form doctrine we are concerned with the intentions at the time of the agreement and economic realities as then perceived by the participants. We are not called upon to restructure the transaction with the benefit of hindsight, for the nature of the stock option depends upon the agreement when entered into, and not upon subsequent action or inaction by the parties. See *Yamamoto v. Commissioner, supra* at 954; *Barrett v. Commissioner*, 58 T.C. 284, 289 (1972).[10] As such, we are not concerned with petitioners' hindsight perspective of the agreement's potential tax benefits as well as their contention that Beverly's services helped ATSA achieve various sales quotas upon which Robert's exercise powers were contingent, or with such subsequent actions as the deposit of the proceeds from petitioners' sale of ATC stock into their joint account.

By focusing on the substance of the agreement at the time the parties made it, we are convinced that the form of the stock option was imbued with economic reality. In making this factual determination, we look to the nature of this compensatory provision vis-a-vis the nature of services which each petitioner as employee performed. ATC structured the stock option essentially as a sales incentive. That is, Robert's exercise of the option was contingent upon ATSA's achievement of various sales goals as well as Robert's continuity of employment. In light of Robert's status as president of ATSA and self-description as "Businessman," we reasonably assume that Robert had a direct impact on ATSA's volume of sales. Petitioners provide no objective evidence that Beverly, in her capacity as administrative secretary, had more than an indirect effect on ATSA's sales volume or that her position was by nature sales-oriented. We are concerned not with Beverly's title as "Administrative Secretary," but rather with her role as perceived by the parties to the agreement when executed. The surrounding facts, including petitioners' documentation on various returns, suggest her role was purely that of secretary and assistant. In consideration of the sales-oriented nature of the incentive stock option, we find it plausible that the form of the incentive stock option, applicable to Robert, alone, was imbued with economic reality.

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[10] See also *Import Specialties, Inc. v. Commissioner*, T.C. Memo. 1982-41.

In petitioners' remaining contention as to the substance of the agreement, they argue that the parties to the agreement actually intended to allocate the stock option between Robert and Beverly. We find this argument unconvincing for two reasons. First, their argument is self-defeating. Petitioners explained that the stock option was structured as it was because the parties to the agreement intended to employ an administratively convenient form. Faced with competing intentions and the choice of tax benefits versus administrative simplicity, petitioners opted for simplicity, and they must accept the tax consequences. It is this type of deliberate choice of one form over another to which the Court in *National Alfalfa* speaks.

Second, petitioners present no objective evidence that the parties to the contract specifically intended when the instrument was executed to allocate the stock option between Robert and Beverly. When an agreement in form is objectively void of any apportionment of the consideration which taxpayer is to receive, taxpayer's unilateral self-serving apportionment of the consideration is not binding upon the Commissioner. Accord *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 682 (5th Cir. 1971) (involving purchaser's unilateral allocation of goodwill to amortizable assets); *Blackstone Realty Co. v. Commissioner*, 398 F.2d 991, 997 (5th Cir. 1968), affg. a Memorandum

Opinion of this Court (involving seller's unilateral valuation of certain component parts of sale). Petitioners present no objective evidence that the parties to the agreement intended to allocate quantitatively part of the option to Beverly, rather than merely to benefit her in a community property sense by compensating her spouse. Therefore, we reject petitioners' argument that their unilateral, self-serving allocation in their amended 1978 return of the stock option proceeds between Robert and Beverly is binding upon the Commissioner.

We hold that the substance of the stock option provision within the employment contract coincided with its form. Consequently, we agree with respondent that Robert, alone, is entitled to report the gain from the disposition of the stock option as earned income for purposes of computing the section 911 exclusion.

Issue 2

The second issue for decision is whether petitioners may attribute any gain from the 1978 disposition of the employee stock option to 1977 under the attribution rule of section 911(c)(2) (now section 911(b)(2)(B)).

On brief, petitioners argue that the proceeds from the sale of the ATC shares "must be equally divided over the years 1977 and 1978 for income tax purposes." According to petitioners, section 911(c)(2) permits their attribution of the proceeds from the stock option to the years in which Robert earned the right to exercise the option. Petitioners assert they earned those rights by their performance of services over the 2-year period of 1977-78, and are entitled to report the proceeds as such.

Respondent argues that petitioners must report the gain entirely in 1978. He relies on the application of the disqualifying disposition provisions of section 421(b)[11] and section 1.421-8(b)(1), Income Tax Regs., which require recognition of gain in the year of disposition. Respondent contends that Robert's exercise of the stock option and disposition of the ATC shares prior to the end of the 2-year holding period constituted a disqualifying disposition of a restricted stock option. As such, he contends petitioners must report the entire gain in the year of the disposition, i.e., 1978. Respondent concludes that this "mandate" as to the time for reporting the gain precludes petitioners from any attribution of gain to the year in which it was earned within the authority of section 911(c)(2).

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[11] Sec. 421(b) provides in pertinent part:

SEC. 421(b). EFFECT OF DISQUALIFYING DISPOSITION.—If the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section * * * 424(a) except that there is a failure to meet any of the holding period requirements of section * * * 424(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occured.

Respondent attempts to buttress his argument by tracing the legislative history of the attribution rule.[12] According to respondent, Congress intended the attribution rule of section 911(c)(2) to apply to such income items as salaries and profit-related bonuses paid after the closing of the taxable year. By contrast, respondent asserts most forms of deferred compensation are ineligible for the foreign earned income exclusion by virtue of section 911(c)(4) (now section 911(b)(1)(B)(iv)).

We reject respondent's arguments; however, we find that petitioners have satisfied their burden of proof only in part. Respondent's argument that petitioners must report income from a disqualifying disposition of a section 424 restricted stock option in the year of disposition serves no purpose in this case, for section 424 is inapplicable here by virtue of the dates on which ATC proposed and granted the option.[13] See secs. 424(b), 424(c)(3). Moreover, respondent's references to the legislative history of sections 911(c)(2) and 911(c)(4) carry little weight with regard to whether petitioners may attribute part of the gain to the taxable year 1977. Respondent shows no trace of congressional intent to preclude the application of section 911(c)(2) to such foreign earned income as exists here. Although section 911(c)(4) may preclude "most deferred compensation" from the exclusion, that provision is inapplicable to the earned income in this case. Section 911(c)(4) explicitly precludes "amount[s] received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed." Robert received the stock option proceeds involved herein, by contrast, within the taxable year after the services were performed.

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[12] Respondent cites S. Rept. 1881, 87th Cong., 2d Sess. 74, 77 (1962), 1962-3 C.B. 707, 783; H. Rept. 1447, 87th Cong., 2d Sess. 54, 56 (1962), 1962-3 C.B. 405, 459-460.

[13] We remind respondent of his ruling that income from the disqualifying disposition of a statutory employee stock option may constitute excludable foreign earned income under sec. 911. Rev. Rul. 69-118, 1969-1 C.B. 135. According to the ruling, the special rules of sec. 911(c), including the attribution of earned income to the period during which the services were performed, govern the reporting of this foreign earned income. Rev. Rul 69-118, *supra*, 1969-1 C.B. at 136.

Nevertheless, section 911(c)(2) does not necessarily permit taxpayers to exclude all of their foreign earned income attributable to the year in which the underlying services were performed. This is a consequence of the limitations on the amount of exclusion provided in section 911(c)(1). The attribution rule in effect puts a cash basis taxpayer on the accrual method of accounting exclusively for the purpose of calculating the section 911 exclusion, and does not affect the time of reporting foreign earned income that is includable in gross income. Section 911(c)(2) provides, "*For purposes of [computing the amount excludable under section 911]*, amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed." (Emphasis supplied.) Section 1.911-2(d)(1), Income Tax Regs., T.D. 6665, 1963-2 C.B. 27, applicable to the tax years in issue, dispels any possible vagueness as to the limited applicability of section 911(c)(2). Section 1.911-2(d)(1), Income Tax Regs., in relevant part provides:

> (1) *Attribution to year in which services are performed.* (i) For purposes of applying paragraphs (a)(4) and (b)(2) of this section, amounts received * * * by an individual shall be considered received in his taxable year in which the services to which the amounts are attributable are performed by such individual.
>
> (ii) The rule of subdivision (i) of this subparagraph *applies only to determine the total amounts attributable to any one year for the purpose of determining the amount of the exclusion* under paragraph (a)(4) or (b)(2) of this section and *does not affect the time of reporting of any amounts which are includible in the individual's gross income.* [Emphasis supplied.]

See *Cook v. United States*, 220 Ct. Cl. 76, 599 F.2d 400, 408 (1979). Needless to say, under section 911 petitioners may not attribute to 1977 any of the gain from the sale of ATC stock for purposes other than applying it against Robert's

$25,000 exclusion for 1977, regardless of when Robert performed the underlying services.

Having determined in issue 1 that the gain from the 1978 sale of ATC stock constitutes foreign earned income of Robert, alone, we find the real issue is whether petitioners may attribute any of the gain to 1977 for purposes of recomputing Robert's 1977 foreign earned income exclusion. Resolution of this issue turns on whether any amount of the gain is attributable to Robert's services performed in 1977 and, if so, whether any of such gain is excludable from 1977 gross income within the applicable section 911 dollar limitations.

We accept petitioners' contention that half of the $195,000 gain from the sale of ATC stock is attributable to services performed in 1977. Petitioners claim that the rights to exercise the stock option on the 10,000 shares of ATC stock were earned from services performed during 1977 and 1978. According to petitioners, half of the gain resulting from the sale of ATC shares is therefore attributable to services performed in 1977. Respondent did not dispute this assertion, and we conclude that respondent concedes this point.

From this part of the gain attributable to Robert's performance of services in 1977, we determine that $4,990.40 is excludable within the section 911 ceiling applicable to Robert for 1977. We compute this figure as follows. For tax years beginning in 1977, individuals who were bona fide residents of a foreign country for an uninterrupted period of 3 consecutive years were entitled to a maximum annual exclusion of $25,000. Sec. 911(c)(l)(B). In petitioners' amended 1977 return, they indicate, and respondent does not dispute, that Robert was such a bona fide resident. According to petitioners' 1977 tax return, Robert's foreign earned income, excluding the stock option proceeds attributable to 1977 services, amounted to $20,009.60. Petitioners are therefore entitled to attribute $4,990.40 of the gain from the 1978 sale of ATC stock to the taxable year 1977 for purposes of computing Robert's section 911 exclusion. To the extent such holding results in an overpayment for 1977, petitioners will be deemed to have amended their petition to request such overpayment. Petitioners may not attribute any of the balance of the gain to 1977 for purposes of the section 911 exclusion.

As a final matter, we must deal with petitioners' motions for dismissal, filed July 15, 1985, and for the award of fees and costs, filed July 15, 1985. Petitioners based their motion for dismissal on events occurring entirely at the administrative level. In rejecting this motion, we remind petitioners, as we informed them during the hearing, that trials in the Tax Court are de novo. We must determine petitioners' tax liability based on the merits of the case and not on any previous record developed at the administrative level. *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327-328 (1974).

We also reject petitioners' motion for award of fees and costs pursuant to section 7430, which provides that reasonable litigation costs may be awarded to the prevailing party. Petitioners' motion, filed on the date of the hearing rather than after the service of the written opinion, does not comply with the provisions of Rule 231(a)(2) and is therefore denied.

To reflect the foregoing, as well as concessions,

An appropriate order will be issued and decision will be entered under Rule 155.

GULF OIL CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22499-82. Filed August 26, 1986.

Afran, a wholly owned foreign subsidiary of P, in the normal course of business, chartered several tanker vessels to Gulftankers, another wholly owned foreign subsidiary of P. Charter hire rates between Afran and Gulftankers were established at the beginning of each year based upon estimates of the rate that would be charged in an arm's-length transaction. In 1975, P decided to consolidate its foreign marine operations. As a result, P caused Gulftankers to transfer all of its operating assets to Afran in exchange

for a payment obligation from Afran before liquidating into P effective Dec. 29, 1975. In January 1976, but prior to the close of the books for the taxable year 1975, the charter hire rate between Afran and Gulftankers was retroactively reduced by $8.8 million. This adjustment increased the net amount of the obligation given by Afran in return for the assets of Gulftankers. This obligation passed to P in the liquidation of Gulftankers and was satisfied by Afran in 1976. *Held*, P received a constructive dividend as a result of the adjustment of the charter hire rates between its two foreign subsidiaries, Afran and Gulftankers.

Maritima, a Spanish subsidiary of P, agreed to sell an incomplete tanker with a cost of $53.2 million to Petronor, a 40-percent owned Spanish subsidiary of P, for the equivalent of $62.2 million. Petronor agreed to pay $7 million of Maritima's profit to Gulftankers in the form of increased freight rates for crude oil deliveries made to Petronor. Maritima received no consideration for agreeing to this arrangement. The $7-million profit was transferred to Afran as part of its purchase of all of the assets of Gulftankers. As a result of the liquidation of Gulftankers, P received the $7-million profit on the sale of the tanker when Afran subsequently satisfied its obligations incurred on the purchase of the assets of Gulftankers. *Held*, P received a constructive dividend as a result of the diversion of the profit from the sale of the tanker to Gulftankers.

During the taxable years in issue, P and all of its domestic and foreign subsidiaries maintained a centralized cash management accounting system. All intercompany payables and receivables were recorded in the system and were ultimately reduced to a single balance either due from or owing to P by each of its subsidiaries. For periods in excess of 1 year, the balances in two of these accounts reflected a net payable from P to two of its foreign controlled subsidiaries. *Held*, the payable balances in the cash management system constituted "an obligation of a United States person" within the meaning of sec. 956(b)(1)(C). *Held, further*, increases in the payable balances owed by P to two foreign controlled subsidiaries represent earnings of a controlled foreign corporation invested in U.S. property at the close of the taxable year 1974 and dividend income to P. Secs. 951(a)(1)(B), 956(a)(1), I.R.C. 1954.

***J. Waddy Bullion*, *Emily A. Parker*, *Sean T. Crimmins*, *Buford P. Berry*, *J.Y. Robb III*, and *Margaret S. Alford*, for the petitioner.**

***Joel V. Williamson* and *Joseph R. Goeke*, for the respondent.**

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax for the taxable year 1974 in the amount of $80,813,428 and for the taxable year 1975 in the amount of $166,316,320. Petitioner and respondent, by motion granted on November 10, 1983, agreed that certain issues would be severed and tried at a special trial session, which was held at Dallas, Texas.

One of the group of issues tried was designated by the parties as "Constructive Dividends and Payables." This group requires the resolution of three issues: (1) Did the retroactive adjustment of marine charter hire rates between two subsidiaries of Gulf result in a constructive dividend to Gulf; (2) did the diversion of a portion of the profit from the sale of an oil tanker ship by one subsidiary to another subsidiary by means of an increase in the marine freight rate charged by the second subsidiary to the buyer of the tanker result in a constructive dividend to Gulf; and (3) do the uncollected balances owed by Gulf to two of its foreign subsidiaries at the end of the taxable year 1974 constitute investment in U.S. property within the meaning of section 956,[1] resulting in dividend income to petitioner?

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are so found and incorporated by this reference.

Gulf Oil Corp. (hereinafter referred to as petitioner or Gulf) is a corporation organized under the laws of the Commonwealth of Pennsylvania with its principal office in Pittsburgh, Pennsylvania. During the taxable years at issue, Gulf and certain of its subsidiary corporations constituted an "affiliated group" as that term is defined in section 1504. Petitioner, directly and through its foreign subsidiaries and affiliates, is engaged in world-wide exploration, development, production, purchase, transportation, and marketing of petroleum products. Petitioner maintained its books of account for the taxable years in issue on the accrual method of accounting using the calendar year as its taxable year. Gulf, as the common parent of an affiliated group of corporations, timely filed consolidated Federal income tax returns for its taxable years 1974 and 1975 on behalf of itself, and certain of its subsidiary corporations, with the Office of the Internal Revenue Service at Pittsburgh, Pennsylvania.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in issue, and all Rule references are to this Court's Rules of Practice and Procedure.

For convenience, we will set forth separate findings of fact for each of the three issues addressed in this opinion.

Adjustment of Freight Rates Between Afran and Gulftankers

There are generally three types of chartering arrangements common in the marine transportation industry: bare boat charters, voyage charters, and time charters. Under a bare boat charter the vessel and the equipment necessary to make it seaworthy are delivered to the charterer in "bare" condition. The charterer must bear the costs of crew and supplies plus all voyage costs, which include the cost of fuel and port charges. Under a voyage charter the owner bears all capital, operating, and voyage costs and the charterer simply pays a single charge for the use of the vessel. Under a typical time charter the charterer, who must pay all voyage costs in addition to the charter rate, has use of the vessel for a period of time. The charter rate is quoted as a dollar figure per dead weight ton of the vessel per month.

A charter can be set between the parties for any length of time. Charters are generally classified as either long-term, short-term, or spot charters. A short-term charter is in effect for up to 2 years; a charter for a period of more than 2 years is considered to be long-term. A spot charter lasts only for the length of time it takes for the vessel to complete a specific voyage or voyages.

To assist in the communication and comparison of worldwide charter rates, the marine transportation industry developed the worldscale rate index approximately 25 years ago. Each worldscale rate is calculated by assuming a standard vessel and calculating all of the costs of that vessel for each route over which tankers operate in the world. The worldscale rates are adjusted semiannually by a group of London and U.S. tanker brokers to reflect current costs. To illustrate the usefulness of the worldscale rate index, assume a charterer desired to charter a tanker from Puerto La Cruz, Venezuela, to Philadelphia and was quoted a rate of "Worldscale 50," a shorthand expression meaning 50 percent of the worldscale rate. In order to determine the actual cost of the charter, the charterer would consult the worldscale rate schedule. If the worldscale rate for this voyage was $4 per ton of cargo carried, expressed as 100 on the worldscale index, the charterer would know the rate he was being quoted was $2 per ton of cargo.

To further assist in the comparison of marine freight rates, the Average Freight Rate Assessment (AFRA) was developed. AFRA is a calculation by a group of London tanker brokers of actual average freight rates on a monthly basis. Stated in terms of worldscale index rates, AFRA is a composite figure that represents the weighted average rate of all charters currently in effect including long-term, short-term, and spot charters. AFRA is calculated separately for six size classes of vessels.

Both the worldscale rate and AFRA indices have become accepted tools in the industry. While the worldscale rate reflects an estimate of the costs of operating a vessel on a specified voyage, AFRA represents actual current charter rates. However, because the worldscale rate and AFRA reflect the cost of shipping one ton of freight, the indices must be converted into a dollar figure per dead weight ton of vessel so that they may be used to quote time charter rates. Furthermore, because both AFRA and worldscale rates include all costs of moving freight, voyage costs, including fuel and port charges, must be subtracted from these rates to approximate the appropriate rate for a time charter of a vessel.

During the taxable year 1974, Gulftankers, a Liberian corporation, and Afran, also a Liberian corporation, were both wholly owned subsidiaries of petitioner. During the taxable years in issue, Gulftankers and Afran were engaged in the marine transportation business. Afran owned, but did not operate, much of petitioner's oil tanker fleet. During the taxable years in issue, Afran was engaged in the business of time chartering tankers exclusively to Gulftankers, which operated the tanker fleet. Gulftankers, in turn, transported oil world-wide on behalf of Gulf subsidiaries and affiliates.

However, as much as 25 percent of the gross income of Gulftankers was generated by spot chartering surplus vessels to unrelated parties.

From 1971 through the taxable years in issue, Afran chartered vessels to Gulftankers by way of consecutive 1-year time charter agreements. These agreements required the payment by Gulftankers of arm's-length time charter rates for each vessel. The rates were established at the beginning of the year based upon an analysis of short-term time charter rates being charged at that time.

To arrive at the arm's-length figure for charter hire rates between Afran and Gulftankers, the assistant comptroller of worldwide marine transportation for Gulf wrote to the director of the foreign flag chartering department for Gulf at the beginning of each year requesting current worldscale rates for the vessels under charter to Gulftankers. After receiving this information, the comptroller's office converted the worldscale rates into time charter rates for use in assessing intercompany charges against Gulftankers on behalf of Afran.

In 1975, Afran had 17 vessels under charter to Gulftankers. In early 1975, Chester Nowak of Gulf's comptroller's office wrote to W.R. Shaunessy of Gulf's chartering department requesting information to make the intercompany charter charges between Afran and Gulftankers. By letter dated February 7, 1975, Shaunessy provided an estimate of 1975 arm's-length charter rates for the vessels owned by Afran that were chartered to Gulftankers. The rates supplied by Shaunessy were based upon worldscale rates reported for the last quarter of 1974 and upon his informal discussions with unrelated tanker brokers, and reflected a projection of arm's-length rates for 1975. This information was used by the comptroller's office to establish the intercompany charter charges for 1975.

During 1975, but after the charter hire rates between Afran and Gulftankers were set, the world-wide demand for tankers declined severely with the result that charter hire rates dropped substantially. The drop in charter hire rates was reflected in concommitant declines in the worldscale rates and AFRA indices. Because the spot charter rates are more volatile than short- and long-term time charters, the drop in the spot charter rates was dramatic.

The Tax Reduction Act of 1975, Pub. L. 94-12, 89 Stat. 26, made several changes in subchapter N, part III, subpart F, Controlled Foreign Corporations, of the Internal Revenue Code (hereinafter referred to as subpart F) regarding the taxation of controlled foreign corporations effective for taxable years beginning after December 31, 1975. Confronted with these changes, Gulf decided that the structure of its foreign shipping operations around several foreign subsidiaries would become disadvantageous after 1975. Therefore, Gulf decided to transfer to Afran all of the assets of Gulftankers, including the time charter agreements between Afran and Gulftankers. Gulftankers was then liquidated into Gulf effective December 29, 1975. Gulftankers' preliquidation balance sheet as of December 29, 1975, reflected a receivable from Afran arising out of the transfer of its assets in the amount of $74,768,947.

On January 13, 1976, before the books of Gulftankers were closed for the taxable year 1975, F. Leo Faust, Jr., of Gulf's tax department instructed Chester Nowak of the comptroller's office to adjust the charter hire rates between Afran and Gulftankers retroactively for the taxable year 1975. The charter rates were adjusted to an amount calculated by a composite of 75 percent of the average spot charter rate for most of 1975, obtained from an industry publication, and 25 percent of the full composite AFRA rates for 1975. The combination of spot and AFRA, like the rate determined at the beginning of 1975, had to be adjusted to eliminate voyage costs and converted to a per-dead-weight-ton figure for use as a charter rate. Heavily weighting the volatile spot component of the composite adjustment factor caused a substantial reduction in the charter rates used between Afran and Gulftankers. In one instance, the comptroller's department had to increase the figure used for the spot component of the adjustment because adjusting based upon actual spot would have resulted in a negative charter rate. This adjustment reduced the 1-year charter rate between Afran and Gulftankers in the total amount of $8,805,000. The adjustment in charter hire rates had the effect of increasing the receivable from Afran on Gulftankers' preliquidation balance sheet by $8,805,000. The Gulftankers' receivable from Afran, which was held by Gulf after the liquidation of Gulftankers, was satisfied in full in March 1976.

The adjustment made on January 13, 1976, was the first such retroactive adjustment made to the charter rates between Afran and Gulftankers since they first entered into 1-year time charter agreements in 1971. The director of foreign flag chartering was not contacted concerning the decision to adjust the charter hire rates between Afran and Gulftankers. Such an adjustment of short-term time charter was virtually unknown in the industry and only occurred in the event of hardship to one of the parties to a time charter agreement. Furthermore, the use of a composite of AFRA and spot rates was not a methodology used in the industry to set time charter rates.

For the taxable year 1975, the Commissioner determined that Gulf realized a constructive dividend from Afran in the amount of $7,247,000 based upon the downward adjustment of the charter rates charged by Afran to Gulftankers under the 1-year time charter in effect for that year. As of December 31, 1975, the current or accumulated earnings and profits of Afran equaled or exceeded the amount determined by the Commissioner to be a constructive dividend distribution.

Sale of La Santa Maria

By agreement dated November 22, 1969, between Gulf and Astilleros y Talleres del Noroeste, S.A. (Astano), an unrelated Spanish shipbuilding corporation, Astano agreed to construct an oil tanker of approximately 324,000 dead weight tons, which was later named *La Santa Maria.* Because *La Santa Maria* was to operate as a Spanish-flag vessel, Gulf at all times intended to transfer ownership of *La Santa Maria* to a Spanish corporation, Compania Maritima Rio Gulf, S.A. (Maritima). Gulf indirectly owned 39.7 percent of Maritima through Transocean Gulf Oil Co. (Transocean), a wholly owned Delaware subsidiary, and the remaining 60.3 percent indirectly through other subsidiaries. Gulf was a party to the construction contract only because Astano so insisted.

Maritima and Gulf arranged for initial long-term financing of up to $35 million to pay for *La Santa Maria* from three French banks, Banque WORMS, Banque de l'Indochine, and Credit Industriel et Commercial. Financing was arranged through the French banks to take advantage of favorable interest withholding provisions in a Franco-Spanish tax treaty. The terms of the initial loan agreement, executed by Maritima and the banks on March 26, 1972, called for the repayment of all advances in 40 semi-annual installments. In order to obtain approval for the loan from the central bank of Spain, Banco de Espana, which was required for all borrowing by Spanish corporations from non-Spanish sources, Maritima could not prepay the loan for 10 years. Security for this loan was provided by dollar deposits made by another Gulf subsidiary for the account of the three French banks in amounts equal to the advances made under the loan to Maritima. Gulf was not a party to the loan agreement or the security agreement.

Before *La Santa Maria* was completed, the decision was made to increase the size of the vessel to approximately 360,000 dead weight tons. In March 1974, the construction contract with Astano was amended to reflect the increased size and cost of the vessel. By letter dated October 2, 1974, Gulf formally assigned the Astano construction contract concerning the incomplete *La Santa Maria* to Maritima.

Prior to completion of *La Santa Maria*, officials of Gulf and Maritima determined that the tanker could not be utilized as planned, in part because of the failure of the Spanish Government to improve the seaport at Huelva, Spain, to accomodate very large vessels such as *La Santa Maria*. Therefore, Gulf and Maritima decided to sell *La Santa Maria* to Refineria de Petroleos del Norte, S.A. (Petronor), a Spanish corporation, 40-percent owned by Gulf, that operated an oil refinery near the deep water port at Bilbao, Spain.

The transfer of *La Santa Maria* was to be accomplished by the assignment of the Astano construction contract from Maritima to Petronor. So that Petronor could avoid certain Spanish taxes on the transaction, Gulf and Maritima agreed to make all remaining payments due under the construction contract prior to the assignment to Petronor. In view of the new specifications agreed to by Astano and Gulf, the decision to prepay the construction contract required that Maritima acquire additional financing to complete payment of the final cost of the vessel, $53.2 million. As a result, with the permission of Banco de Espana, in May 1975, Maritima entered into a loan agreement with two of the same French banks that provided the initial financing, Banque WORMS and Credit Industriel et Commercial. The supplemental financing agreement provided for a $20-million short-term loan to Maritima prepayable at any time. This loan was secured by guarantees provided by Gulf rather than dollar deposits.

Petronor ultimately agreed to pay the equivalent of $62.2 million as the purchase price for *La Santa Maria*. After subtracting the total cost of $53.2 million, which Petronor paid in an equivalent amount of Spanish pesetas, Maritima realized a profit of $9 million. Maritima and Petronor agreed that the profit would be reduced by $2 million as a retroactive reduction in the price of certain crude oil purchases by Petronor. The reason for this adjustment was that certain deliveries of crude oil to Petronor contained excessive amounts of basic sediment and water. Gulf originally contemplated that the remaining profit on the sale of *La Santa Maria* would be paid via increased freight rates paid by Petronor to Maritima retroactively to January 1, 1974. Ultimately, however, Petronor agreed to divert the remaining $7 million profit from Maritima to Gulftankers, another Gulf subsidiary, by way of increased freight rates paid by Petronor to Gulftankers, which delivered crude oil to Petronor in its non-Spanish flag vessels in the regular course of its business. Maritima received no consideration from Gulftankers, Petronor, or Gulf for the agreement to give up its profit on the sale of *La Santa Maria*.

The exchange of the $53.2 million in pesetas for dollars necessary to repay the French loans required the approval of Banco de Espana. Maritima was allowed to exchange $20 million in pesetas immediately and repaid the supplemental short-term loan from the French banks. However, permission was not immediately granted to exchange the remaining $33.2 million in pesetas for dollars to repay the initial loan. Without special permission the $33.2 million in pesetas could only be converted in an amount equal to that required to make the regular installment payments due under the loan until the 10-year prepayment prohibition expired. As Maritima had no business use for pesetas in Spain, the "blocked" pesetas created considerable concern among the management of Gulf and Maritima. Numerous internal correspondence and memoranda at Gulf discussed ways to expatriate the "blocked" pesetas or, at a minimum, to shield those pesetas from interest rate, devaluation, and political risks. The internal documents of Gulf make clear that Gulf, and not solely Maritima, was the party most interested in repatriating the blocked pesetas. Ultimately, permission to convert the blocked pesetas to dollars was granted by Banco de Espana and the loan was repaid after the taxable years in issue.

The freight rate adjustment to which Petronor agreed was reflected as "deferred revenue" in the total amount of $6,611,844 on the financial records of Gulftankers. The deferred revenue account was transferred to Afran prior to the liquidation of Gulftankers into Gulf on December 29, 1975. The transfer to Afran of the deferred revenue account resulted in an increase in the payable from Afran to Gulftankers arising out of the transfer of all of the assets of Gultankers.

The Commissioner determined that Gulf received a constructive dividend for the taxable year 1975 equal to the freight rate adjustment of $6,611,844. The Commissioner determined, in the alternative, that Transocean, a wholly owned Gulf subsidiary, realized a constructive dividend in the same amount for the taxable year 1975. As of December 31, 1975, the current or accumulated earnings and profits of Petronor and Maritima each equaled or exceeded $6,611,844.

Payables to GS & D and Gulf Overseas

During the taxable years in issue, Gulf and its affiliates maintained a centralized cash management system to record and offset intercompany payables and receivables. This system was designed to minimize cash transfers among affiliated companies and to maximize the availability of cash for investment opportunities. In the most general terms, these goals were met, in the case of transactions between an affiliate and an unrelated person, by having Gulf actually disburse or receive any cash payments required in the transaction on behalf of its affiliate. Movements of cash in transactions between affiliates were minimized by having those payment obligations represented as intercompany receivables or payables subject to offset by other transactions of the affiliates with Gulf or other affiliates.

The centralized cash management system was reflected in the bookkeeping records of Gulf in four accounts, designated in its uniform system of accounts as accounts 1950, 1960, 1970, and 1980. Account 1950 is used to record the balance of long-term intercompany receivables and payables between Gulf and its affiliates. A separate 1950 account was maintained with respect to each affiliate in the unconsolidated financial records of Gulf and the balance shown therein reflected the intercorporate receivable due Gulf from the affiliate or payable due the affiliate from Gulf. Each affiliate also maintained an account 1950 in its financial records reflecting the same amount shown on Gulf's records as due from or owing to Gulf.

The operation of the cash management system may be illustrated, in the case of transactions with unrelated parties, as follows: Affiliate, in the ordinary course of its business, manufactures and sells products to unrelated parties. Affiliate also purchases necessary materials from unrelated parties. Upon the purchase of materials, Affiliate requests Gulf to disburse the cash to the materials vendor. Upon making the payment on behalf of Affiliate, Gulf records a credit to "cash" and a debit to the intercompany receivable account established for Affiliate, "1950-Affiliate," in the amount of the payment. On its books of account, Affiliate shows the amount of the payment in its 1950 account as a credit to reflect the payable to Gulf, and debits its purchases account in the same amount. When Affiliate sells its product, the purchaser is directed to remit the purchase price directly to Gulf, which deposits the cash in its bank account, debits "cash," and credits "1950-Affiliate" on its books of account in the amount that was received as payment for the product. Simultaneously, Affiliate would record the sale in its books of account as a debit to its 1950 account to show the receivable from Gulf and credit "sales" for the amount of the price charged for the product sold.

Generally, all transactions between Gulf and its affiliates and among its affiliates are accomplished without the actual transfer of cash. Under Gulf's cash management system, such intercompany transactions are ultimately reflected as a single balance representing either an amount owed to the affiliate or owed to Gulf in account 1950. However, unlike a transaction with an unrelated party, the path to a single 1950 balance between Gulf and each of its affiliates is less direct.

Generally, receivables and payables generated by transactions by an affiliate with Gulf or with other affiliates are initially recorded in account 1970. An affiliate has a separate 1970 account for each affiliate with which it does any business. For example, if Affiliate A purchases material from Affiliate B and sells finished products to Affiliate C, Affiliate A will record in its books of account a credit to its account "1970-Affiliate B" in the amount of the purchases and a debit to its account "1970-Affiliate C" in the amount of the sales price for the finished products. Correspondingly, Affiliates B and C will record these transactions in their "1970-Affiliate A" account as a debit and a credit, respectively. At the end of each month, each affiliate's 1970 account balances are cleared by way of reversing journal entries and the aggregate amount from these accounts is recorded as a receivable or payable directly with Gulf in account 1960. The transfers to account 1960 consolidate multiple intercompany receivable and payable balances into a single amount either due to or owed by Gulf with respect to each affiliate. A 1970 account will not be cleared to account 1960 in the event one of the affiliates that was a party to an intercompany transaction failed, because of human error or otherwise, to record the receivable or payable in its 1970 account for the other affiliate. Only if both affiliate's respective 1970 accounts are in balance will they be subject to the monthly clearinghouse effect of account 1960.

Account 1980 closely resembles account 1970 in purpose. However, unlike 1970 accounts, a company that uses account 1980 instead of or in combination with account 1970 will not automatically clear the account on a monthly basis, but only after overt action by the comptroller's office. There are various reasons why an affiliate might use account 1980; one of which is that foreign subsidiaries may be required under the currency regulations of the country of their incorporation to settle receivables and payables in cash rather than by intercompany offset.

The balances in account 1960 between Gulf and each affiliate are reviewed on a quarterly basis. At the close of the following month, the balances in the 1960 accounts are recharacterized as long-term receivables or payables and transferred to account 1950 for later settlement.

Although each 1950 account represents a net payable or receivable between Gulf and one of its affiliates, there is no set time for settlement. No formal notes were executed between Gulf and its affiliates in regard to the obligation evidenced by the balances in the cash management accounts. No interest was charged or paid on the amounts reflected in the cash management accounts during the taxable year in issue.

At issue in this case are the tax consequences of the payable balances in accounts 1950 maintained by Gulf for two of its foreign subsidiaries, Gulf Overseas Co., Inc. (Gulf Overseas) and Gulf Supply and Distribution (GS & D). During the taxable year 1974, Gulf owned 100 percent of Gulf Overseas, a Panamanian corporation. During the taxable years 1974 and 1975, Gulf owned 100 percent of GS & D, a Bahamian corporation, indirectly through other wholly owned subsidiaries. Gulf Overseas engaged in the business of trading liquidified petroleum gas (LPG) products and GS & D purchased and sold aviation fuel.

Pursuant to Gulf's cash management system, the proceeds of the sale of LPG product sold by Gulf Overseas and the proceeds of the sale of aviation fuel sold by GS & D were paid directly to Gulf by the purchasers and recorded in the appropriate 1950 accounts. Also pursuant to the cash management system, the intercompany obligations incurred in the purchases of LPG and aviation fuel by Gulf Overseas and GS & D were initially recorded in the 1970 or 198 account established by Gulf Overseas and GS & D for th affiliate with which the purchase transactions occurred. I accordance with the cash management system, the balance shown in the respective accounts 1970 and 1980 wer ultimately converted into a single net receivable or payabl between Gulf and Gulf Overseas and GS & D by transfer t account 1960, the balance of which was transferred t account 1950 on a quarterly basis.

Shown below are the end of month balances of Gul Overseas for accounts 1950, 1960, and the aggregate end o month balances of accounts 1970 and 1980 as shown on th books of account of Gulf Overseas:

GULF OVERSEAS CO., INC.

ANALYSIS OF GULF RECEIVABLES AND PAYABLES IN ACCOUNTS 1950, 1960 AND AGGREGATE ACCOUNTS 1970 AND 1980 BALANCES FOR THE PERIOD FROM 12/31/73 TO 12/31/75

	Long-term 1950	*Short-term 1960*	*Short-term 1970*	*Short-tern 1980*
December 1973	$3,734,165	(1)		($100)
January	5,474,458	(1)		(100)
February	6,482,215	(2)		(100)
March	15,848,437	(1)		(100)
April	21,254,822	(2)		(3,017)
May	24,403,795	(2)		(5,074)
June	30,605,277	(2)		(5,074)
July	39,402,887	1		(5,074)
August	44,311,137	(2)		(5,074)
September	14,467,050	(2)		(5,431)
October	17,905,758	(1)	($5,871,779)	(5,431)
November	21,341,065	(5,871,780)	(3,579,613)	(5,431)
December 1974	13,999,541	(1)		(5,431)
January	17,789,245	(1)	(2,825,790)	(5,431)
February	24,367,165	(2,825,790)	(16,545,818)	(5,431)
March	23,699,562	(16,545,819)	(2,949,831)	
April	26,177,876	(19,495,649)	(2,679,342)	
May	29,762,446	(22,174,991)	(4,245,182)	
June	12,026,374	(4,245,182)	(5,029,837)	
July	13,627,894	(9,275,019)	(3,160,447)	
August	13,627,894	(12,435,467)	1,362,346	
September	6,093,598	6,041,009	(3,869,397)	
October	6,093,598	6,042,431	(7,038,289)	
November	6,093,598	(995,858)	(2,663,768)	
December 1975		(55,197)		

A positive or debit balance in the entries in the above table indicates a net receivable, while a negative or credit balance indicates a net payable. The very small balances shown under the heading for "Short-Term 1960" represent rounding adjustments.

For the taxable year 1974, the Commissioner determined that the increase in the 1950 account receivable balance between Gulf and Gulf Overseas from the beginning balance of $3,734,165 to the ending balance of $13,999,541, or $10,265,376, represented investment in U.S. property within the meaning of section 956(a)(1) and (b)(1)(C). Therefore, the Commissioner determined that Gulf realized additional taxable income under sections 951 and 956 equal to $662,248, an amount not exceeding the earnings and profits of Gulf Overseas.

Shown below are the end of month balances of GS & D for accounts 1950, 1960, and the aggregate end of month balances of accounts 1970 and 1980 as shown on the books of account of GS & D

GULF SUPPLY AND DISTRIBUTION CO., LTD.
ANALYSIS OF GULF RECEIVABLES & PAYABLES
IN ACCOUNTS 1950, 1960 & AGGREGATE ACCOUNTS
1970 AND 1980 BALANCES FOR THE PERIOD
FROM 12/31/73 TO 12/31/75

	Long-term 1950	*Short-term 1960*	*Short-term 1970*	*Short-term 1980*
December 1973				
January				
February				
March				
April				
May				
June			$457,745	
July			1,707,739	($898.514)
August		$1,713,817	(30,855)	(935,000)
September		1,689,040	862,080	(1,549,636)
October		2,557,198	(105,394)	(2,112,737)
November		2,451,804	704,614	(1,747,244)
December 1974	$2,451,804	704,614		(2,746,333)
January	2,451,804	704,614	665,401	(2,583,234)
February	2,451,804	1,370,016	295,780	(2,761,388)
March	3,821,820	295,780	135,438	(2,418,953)
April	3,821,820	431,218	496,513	1,599,001

	Long-term 1950	*Short-term 1960*	*Short-term 1970*	*Short-term 1980*
May	$3,821,820	$927,731	$705,325	$2,133,940
June	4,749,551	705,325	1,310,256	3,538,694
July	4,749,551	2,015,581	1,917,640	15,005,236
August	4,749,551	3,933,221	1,184,079	15,005,236
September	8,682,772	1,184,079	1,806,164	8,985,405
October	8,682,772	2,990,244	1,638,234	9,271,899
November	8,682,772	4,628,477	940,643	1,991,435
December 1975	9,620,409	1,733,081		243,127

For the taxable year 1974, the Commissioner determined that the increase in the 1950 account receivable balance between Gulf and GS & D equal to the ending balance of $2,451,804 represented investment in U.S. property within the meaning of section 956(a)(1) and (b)(1)(C). Therefore, the Commissioner determined that Gulf realized additional taxable income under sections 951 and 956 equal to $410,084, an amount not exceeding the earnings and profits of GS & D.

OPINION

The Commissioner determined that Gulf received constructive dividends based upon the retroactive adjustment of the charter hire rate between two of its subsidiaries, Afran and Gulftankers, and the increase in the freight rate charged by Gulftankers to Petronor in connection with the sale of *La Santa Maria* by Maritima, another Gulf subsidiary. The Commissioner also determined that Gulf realized taxable income for the taxable year 1974 under section 956 resulting from the increase in balances of accounts payable to two of its foreign subsidiaries. These determinations by the Commissioner are presumptively correct and petitioner bears the burden of proof. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). For clarity we have divided our opinion into separate sections dealing with the constructive dividends issues and the section 956 issue.

Constructive Dividends

Under section 61(a)(7), gross income includes dividends. The term "dividend" is defined in section 316(a) as a distribution of property by a corporation to its shareholders out of its earnings and profits. There is no requirement that the dividend be formally declared or even intended by the corporation. See, e.g., *Sachs v. Commissioner*, 277 F.2d 879 (8th Cir. 1960), affg. 32 T.C. 815 (1959). Distributions by a corporation will be treated as dividends to the shareholder if the distributions are made for the shareholder's personal benefit; the funds need not be distributed directly to the shareholder. *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971), affg. 52 T.C. 888, 893 (1969); *Rapid Electric Co. v. Commissioner*, 61 T.C. 232, 239 (1973). It is also clear that a transfer of property from one corporation to another corporation can constitute a constructive dividend to their common shareholder. *Sammons v. Commissioner*, 472 F.2d 449 (5th Cir. 1972), affg. in part, revg. in part, and remanding a Memorandum Opinion of this Court.

Before we will characterize a transfer of property from one corporation to another as a constructive dividend to a common owner, we must first examine the transfer under a two-part test.[2] The first, or objective, part of the test asks: "did the transfer cause funds or other property to leave the control of the transferor corporation and did it allow the stockholder to exercise control over such funds or property either directly or indirectly through some instrumentality other than the transferor corporation." *Sammons v. Commissioner*, *supra* at 451. The second, or subjective, test requires that we determine whether the transfer was prompted primarily by a business purpose of the transferring corporation or rather a shareholder purpose of the common owner. *Sammons v. Commissioner*, *supra* at 451.

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[2] We do not agree with petitioner that an allocation by the Commissioner under sec. 482 is a prerequisite to a determination that a constructive dividend has been made because of intercompany transfers. Application of sec. 482 lies within the discretion of the Commissioner, and the taxpayer cannot require its use. Sec. 1.482-1(b)(3), Income Tax Regs. In its brief, petitioner cites no authority for its position and merely argues that the failure of the Commissioner to use sec. 482 denies it the opportunity to avail itself of certain relief provisions available only after a sec. 482 allocation is made. See, e.g., Rev. Proc. 65-17, 1965-1 C.B. 833; Rev. Rul. 82-80, 1982-1 C.B. 89. Petitioner's argument relies solely on vague notions of fairness. Even if the relief provisions referred to by petitioner would have been available in the event of a sec. 482 allocation, a requirement that the Commissioner use sec. 482 before determining that a constructive dividend has been paid would improperly impinge on the discretion of the Commissioner.

Retroactive Change in Charter Hire Rates Between Afran and Gulftankers

We have no difficulty finding that the agreement by Afran to accept retroactive reduction in the charter hire rate for the vessels chartered to Gulftankers under 1-year time charter agreements represents a transfer of property from one corporation to another corporation, both of which were under the common control of Gulf. Afran had a right to receive charter income at the higher rate negotiated at the beginning of 1975 and, by acceding to the charter hire rate reduction, gave up property equal in value to the amount of the aggregate charter hire rate adjustment. We need say no more about the objective test; the more critical inquiry in this instance is whether the primary purpose of the transfer was for the benefit of the common owner, Gulf.

Petitioner argues that the adjustment to the charter hire rates was in keeping with its practice of setting those rates at fair market value. We are not persuaded that this was the purpose of the adjustment. The 1-year time charter agreements, which are not in the record, require that the charter hire rate be set at the beginning of the year. In accordance with the charter agreements and with the assistance of Gulf's marine charter department, the rates were set at the beginning of the year 1975 at an estimate of the rate that would be charged for 1-year time charters in an arm's-length transaction. This was the same procedure that had been followed since 1971 when the arrangement between Afran and Gulftankers began. In January 1975, the rate was set based upon recently published worldscale rates, which were converted to a per-dead-weight-ton figure, and upon information obtained from professional tanker brokers. The rate thus established was a reasonable estimate of the rate that would be charged in an arm's-length transaction at the beginning of 1975. The adjustment in the 1975 charter hire rates represented the first time such an adjustment was made. Such retroactive adjustments to 1-year time charters were virtually unknown in the industry. Furthermore, the use of a composite rate strongly weighted in favor of the spot charter rate was not a method used in the industry to set short-term time charters. Perhaps even more telling is the fact that the adjustment was made at the direction of Gulf's tax department and without consultation with the marine chartering department.

We doubt that such adjustments were called for in the agreements between Afran and Gulftankers. We have found as fact that the tanker market experienced a severe decline in 1975; however, petitioner has not demonstrated that there was any hardship to either Afran or Gulftankers caused by the decline in the tanker market. In the absence of a specific provision pegging the contract price to some floating market rate, it seems to us that market fluctuations are one of the risks accepted by the parties to any continuing agreement whether the contract is long-term or only for 1 year as in this case. When an agreement calls for the price or rate to be fixed at the beginning of the period of the agreement, the reasonableness of the rate viewed with the clarity of hindsight is not generally relevant. Even if the rates as adjusted were equal to fair market value for the taxable year 1975 and Afran had a business purpose for reducing the charter hire rate without any consideration, which we doubt, we find that the very real and direct benefit accruing to the common shareholder, Gulf, constitutes the primary purpose for the adjustment.

In contemplation of its liquidation, Gulftankers transferred all of its assets, including the time charter agreements with Afran, to Afran. To reflect this transaction Gulftankers recorded in its books of account a very large amount receivable from Afran. This receivable was distributed to Gulf in liquidation of Gulftankers. As a result of the charter hire rate adjustment, the amount of charter fees Gulftankers owed Afran under the 1975 time charters was reduced by approximately $8.8 million. This adjustment caused a corresponding increase in the net payable from Afran to Gulftankers arising out of the preliquidation transfer of assets of $8.8 million. The net effect of the sale of Gulftankers' assets, its subsequent liquidation into Gulf, and the charter hire rate adjustment was that Gulf received $8.8 million as a tax-free repayment of debt. If the charter hire rates had not been adjusted, Afran would have recognized an additional $8.8 million in gross income. If the $8.8 million were paid by Afran to Gulf as a distribution of earnings and profits, it would have resulted in a taxable dividend to Gulf for which no dividends received deduction would have been allowable. Secs. 243, 301(c), 316.

Petitioner argues that any benefit received by Gulf was indirect. In this regard petitioner contends that the rate adjustment and the liquidation of Gulftankers were unrelated events and that we should ignore the latter. We refuse to do so. Although there was a business purpose for consolidating Gulf's foreign shipping operations, we cannot ignore the fact that the decision to liquidate Gulftankers provided petitioner with what it must have thought were inviting tax planning opportunities. For whatever reason, Gulftankers was liquidated near the end of the taxable year 1975. As a result, petitioner directly benefited from a transaction, the charter hire rate adjustment, nominally carried out by two affiliated corporations. We uphold the Commissioner's determination on this issue.

Sale of La Santa Maria

We are quite satisfied that the diversion of part of the purchase price of *La Santa Maria* from the seller, Maritima, to another Gulf subsidiary, Gulftankers, via an increase in freight rates charged to the purchaser constitutes a transfer of property between two corporations under common ownership. Petitioner concedes as much on brief. Again the critical inquiry is whether the principal purpose of the transfer was to confer a benefit upon the transferring corporation or upon the common shareholder. Petitioner contends that the primary purpose of the freight rate increase was the desire by Maritima to expatriate part of the purchase price by legal means. Petitioner claims that Maritima had no business use for pesetas and that there was, therefore, a valid business purpose for the arrangement with Petronor to pay higher freight rates to Gulftankers.

Although respondent does not contest the uncontroverted testimony offered by petitioner that the $7 million profit could not be converted from pesetas to dollars, we can certainly find no business purpose of Maritima served by allowing its profit from the sale of *La Santa Maria* to be deflected to Gulftankers without any consideration in return. We believe a more likely conclusion to be drawn from this record is that the arrangement whereby Gulftankers received Maritima's profit from the sale of *La Santa Maria* primarily served a shareholder purpose. Following the results of this arrangement, we see that the diverted profit from the sale of *La Santa Maria* first appeared as a "deferred revenue" account on the books of Gulftankers in the amount of $6,611,844. This asset, along with the remainder of the assets of Gulftankers, was conveyed to Afran prior to the liquidation of Gulftankers. The profit from *La Santa Maria* thus appeared as an increase in the amount receivable obtained by Gulftankers in exchange for all of its assets, including the "deferred revenue" account. Finally, after the liquidation of Gulftankers, Gulf received the profit from the sale of *La Santa Maria* in the form of tax-free repayment of debt when Afran satisfied this obligation the following year. As can be seen, Gulf, and not Maritima, received a very real benefit from the arrangement to divert the profit from the sale of *La Santa Maria* away from Maritima.

We are also satisfied that the benefit obtained by Gulf was sufficiently direct and was the primary purpose for this transaction. Again we refuse to ignore the fortuitous timing of the liquidation of Gulftankers in determining whether Gulf received a direct, rather than indirect, benefit. The consolidation by Gulf of its foreign marine operations was an independent event, but its occurrence allowed Gulf to receive income from one of its foreign subsidiaries free from U.S. tax, which, if not for the arrangement between Maritima, Petronor, and Gulftankers, would likely have been repatriated only as a taxable dividend. Our conclusion is confirmed by our finding that petitioner contemplated as late as July 1974, that the profit from the sale of *La Santa Maria* would be paid via increased freight rates paid by Petronor to Maritima. Only later did petitioner decide to insert Gulftankers into this transaction.

Because the diverted profit from the sale of *La Santa Maria* came into the hands of Gulf, this case is distinguishable from those cases cited by petitioner wherein it was determined that the benefit conferred upon the common shareholder was too indirect to support the determination of a constructive dividend. See *White Tool & Machine Co. v. Commissioner*, 677 F.2d 528 (6th Cir. 1982), cert. denied 459

U.S. 907 (1982), affg. a Memorandum Opinion of this Court; *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971), affg. 52 T.C. 888 (1969); *R.T. French Co. v. Commissioner*, 60 T.C. 836, 854-856 (1973).

We uphold the Commissioner's determination on this issue.

Section 956

We now turn to the question of whether Gulf realized taxable income from two wholly owned foreign subsidiaries due to large payable balances remaining in Gulf's centralized cash management accounting system at the end of the taxable year 1974. The Commissioner based his determination that Gulf received taxable income from Gulf Overseas and GS & D for the taxable year 1974 in the amounts of $662,248 and $410,084, respectively, by virtue of sections 951 and 956 of Subpart F of the Internal Revenue Code. The resolution of this issue requires that we decide whether increases in the balances of account 1950 of Gulf's cash management system, reflecting long-term payables from Gulf to Gulf Overseas and GS & D, represent an increase in the earnings of controlled foreign corporations invested in U.S. property. Sec. 951(a)(1)(B); sec. 956.

Section 951 provides:

> SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.
>
> (a) AMOUNTS INCLUDED.—
>
> (1) IN GENERAL.—If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder * * * of such corporation and who owns * * * stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—
>
> (A) the sum of—
>
> * * * * * * *
>
> * * *; and
>
> (B) his pro rata share * * * of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

Section 956 provides:

> SEC. 956. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

> (a) GENERAL RULES.—For purposes of this subpart—
>
> (1) AMOUNT OF INVESTMENT.—The amount of earnings of a controlled foreign corporation invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend (determined after the application of section 955(a)) if it had been distributed.
>
> * * * * * * *
>
> (b) UNITED STATES PROPERTY DEFINED.—
>
> (1) IN GENERAL.—For purposes of subsection (a), the term "United States property" means any property acquired after December 31, 1962, which is—
>
> * * * * * * *
>
> (C) an obligation of a United States person; * * *

Sections 951(a)(1)(B) and 956 were enacted as part of Subpart F by the Revenue Act of 1962 (Pub. L. 87-834, 76 Stat. 960) in response to perceived abuses by U.S. taxpayers through the use of controlled foreign corporations. These particular sections were aimed at preventing the repatriation of income to the United States in such a way that the income is not subject to U.S. taxation. H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 462. By taxing U.S. shareholders on the increased investment of their controlled foreign corporations in the United States, Subpart F treats the amount of the increased investment much like a constructive dividend to the U.S. shareholders. See H. Rept. 1447, *supra*; S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 794; *Dougherty v. Commissioner*, 60 T.C. 917, 926, 929 (1973).

The parties are in apparent agreement that Gulf Overseas and GS & D are foreign corporations controlled, within the meaning of section 958, by a U.S. shareholder, Gulf. The parties also agree that the balances in account 1950 represent legitimate obligations of Gulf. The point upon which petitioner and respondent part company is whether a balance in a 1950 account is "an obligation of a United States person" within the meaning of the regulations promulgated under section 956.

Section 1.956-2(d)(2), Income Tax Regs., provides that "the term 'obligation' includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest." However, the regulation also excepts from its broad definition of "obligation"

> (ii) Any indebtedness (other than an indebtedness arising in connection with the sale or processing of property) which—
>
> (a) Is collected within one year from the time it is incurred.
>
> [Sec. 1.956-2(d)(2)(ii), Income Tax Regs.]

Petitioner contends that although there were balances in its accounts 1950 payable from Gulf to Gulf Overseas and GS & D throughout the relevant years, because of the many offsetting transactions reflected in account 1950, all of the obligations arising from the individual transactions were collected within 1 year from the time they were incurred. According to petitioner, this result is achieved by offsetting the amount of each new receivable against the oldest payable obligation by way of analogy to the first-in, first-out (FIFO) method of inventory identification and valuation.

Respondent, on the other hand, contends that the payable balances in account 1950 represent one indivisible, although fluctuating, payment obligation to an affiliated corporation. Accordingly, respondent contends that because there were outstanding balances in the Gulf Overseas and GS & D 1950 accounts throughout the relevant times, the obligation represented therein was not collected within 1 year. Furthermore, because the balances in the pertinent accounts 1950 increased from the beginning of the taxable year 1974, to yearend, respondent contends that Gulf must report those increases as taxable income under the nearly mechanical provisions of section 951 and 956(a). We find respondent's arguments to be persuasive.

The cash management system instituted by Gulf decreases inefficient movements of cash in two ways. First, in transactions with unrelated parties, Gulf receives and disburses cash on behalf of its subsidiaries. Payments and receipts of cash by Gulf are then reflected as a payable or receivable in account 1950 on the books of Gulf and its affiliates. Second, the cash management system serves as a clearinghouse to offset intercompany receivables and payables, thereby preventing unnecessary cash movements between related companies. Under the system, intercompany obligations reflected in accounts 1970 and 1980 are moved to account 1960 where they are reduced to single payable or receivable balances between each affiliate and Gulf before they are ultimately recorded in account 1950. Regardless of which path a transaction follows before it is reflected in account 1950, the end result is a single balance representing an obligation between Gulf and one of its affiliates. If an account 1950 shows a negative or credit balance on Gulf's books of account (reflected as a positive or debit balance on the books of the affiliate), this indicates that Gulf owes that affiliate an amount of money equal to the balance of the account. This is nothing more than a single open account loan.

The fact that the individual transactions that give rise to the upward and downward movements in account 1950 lose their individual identity under the cash management system is shown by petitioner's inability to trace individual transactions through the cash management system. The cash management account system was not designed to trace individual transactions on a FIFO basis or otherwise. One of petitioner's witnesses, the director of general administrative accounting in the office of the comptroller for Gulf, testified that he, in the course of his job, had traced only one transaction from account 1950 to its origin; the witness also added that this was the only transaction in that account during the month. In any other circumstances, the tracing required by the FIFO method petitioner alleged to be implicit in its cash management system could only be done through the use of substantial time, money, and manpower. Such theoretical ability to trace the many individual transactions recorded in the cash management system does not make such tracing a part of the system in actuality. Petitioner has failed in its burden of proof on this issue. Rule 142(a).

The cash management system of Gulf and its affiliates apparently satisfied its avowed purposes of avoiding inefficient movements of cash and centralizing cash assets to take advantage of investment opportunities. Nevertheless, this does not alter the fact that the payable balances of the cash management system create one of the situations at which section 956 was aimed. Gulf's foreign affiliates have earned income free from U.S. taxation. Gulf has then repatriated those earnings by way of the large payable balances maintained in its cash management system. Absent the provisions of Subpart F, Gulf has complete and indefinite control over those earnings while the earnings escape U.S. taxation.

So long as there is a credit balance in an account 1950 on the books of account of Gulf, there exists an obligation within the meaning of section 1.956-2(d)(2), Income Tax Regs. In this regard, we are focusing on the existence of a balance and not the fluctuations in that balance. The fluctuations in the balance simply reflect the nature of a loan in the form of an 'open account.' Sec. 1.956-2(d)(2), Income Tax Regs.

Conclusion

We have found in favor of respondent on the constructive dividend issues and the issue on the application of section 956 to the payable balances in petitioner's cash management system. Although we have found for respondent on all the above issues, there are many other issues in this case and a Rule 155 computation will be necessary. We again point out that this opinion resolves certain severed issues only, and that all other issues not previously decided in this case[3] are still before the Court.

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[3] Other issues in this docket have been decided as follows: the "Intangible Drilling and Development Costs" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 87 T.C. 324 (1986); the "Worthless Properties" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 87 T.C. 135 (1986); the "Kuwait Nationalization" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 86 T,C. 937 (1986); the "Iranian Foreign Tax Credit" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 86 T.C. 115 (1986); the "North Sea Farmout" issue was decided by this Court in *Gulf Oil Corp. v. Commissioner*, 84 T.C. 447 (1985).

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UNITED STATES TAX COURT

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Commissioner's Motion To Dismiss for Lack of Jurisdiction—Untimely Petition and Validity of Deficiency Notice—Sec. 6851 as Separate Limitation Period and Last Known Address.—Where Commissioner terminated petitioner's taxable year effective July 3, 1980, and assessed income tax under sec. 6851; on Aug. 14, 1980, petitioner executed power of attorney on preprinted I.R.S. form appointing attorneys-in-fact for his tax liability for termination assessment period, giving address to which communications with attorney should be sent, and listing address for himself at North Miami Beach, Florida; on May 10, 1982, Commissioner mailed duplicate original notices of deficiency for taxable 1980 to petitioner's listed address, albeit at Miami Beach instead of North Miami Beach, and to another address; and petitioner resided in Colombia when petition was filed more than 3 years after mailing of deficiency notice, Court granted Commissioner's motion to dismiss for lack of jurisdiction on ground that petition was filed more than 3 years after mailing of deficiency notice, since (1) sec. 6851 does not constitute separate limitation period for mailing deficiency notice; and, (2) deficiency notice was mailed to petitioner's "last known address" within meaning of sec. 6212(b)(1). *Ramirez v. Commissioner* **643**

Parties' Cross-Motions for Summary Judgment—Preclusion of Evidence Provision in Prior Order—Petitioner's Inability To Carry Burden of Proof.—Where in inplementation of 86 T.C. 468, Court ordered that petitioner be precluded from introducing into evidence books and records of deemed related Swiss corporation, or any information derived therefrom, Court denied petitioner's motion for summary judgment, since it found no reason to modify its prior orders, and granted Commissioner's motion for summary judgment, since there appeared to be no possibility, given preclusion of evidence provision of Apr. 9, 1986, order, that petitioner could carry its burden of proof. *Gerling International Insurance Co. v. Commissioner* **679**

REPORTS
OF THE
UNITED STATES TAX COURT

UNITED STATES TAX COURT—Continued Page

Commissioner's Motion To Dismiss for Lack of Jurisdiction— [illegible]

[illegible]

ROBERT P. OSBORNE AND CAROL A. OSBORNE, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 15999-84. Filed September 4, 1986.

Under local law, the City of Colorado Springs was obligated to provide for the safe discharge of waters within Shook's Run, a natural drainage system which ran through petitioner's property. Petitioner constructed and installed a concrete twin box culvert and related drainage facilities in Shook's Run and transferred them to the city. He also granted easements to the city over the drainage system to facilitate its repair and maintenance. Petitioner claimed a charitable contribution deduction under sec. 170, I.R.C. 1954, for his expenditures incurred in constructing and installing the facilities and for the fair market value of the easements. *Held*, the drainage facilities and easements included both deductible and nondeductible elements and, to the extent they constituted a contribution, were to be used for exclusively public purposes within the meaning of sec. 170(c)(1), I.R.C. 1954. *Held, further*, the extent to which the drainage facilities and easements constituted a charitable contribution determined.

R. Kenneth Sparks, for the petitioners.
Benjamin A. de Luna, for the respondent.

FEATHERSTON, *Judge*: Respondent determined a deficiency in the amount of $14,307 in petitioners' Federal income tax for 1981. The issue for decision is: Whether petitioners are entitled to a deduction for a charitable contribution under section 170[1] for the installation and transfer of drainage facilities and easements to the City of Colorado Springs.

FINDINGS OF FACT

Petitioners Robert P. Osborne and Carol A. Osborne, husband and wife, resided in Colorado Springs, Colorado, at the time the petition was filed. Petitioners filed a joint Federal income tax return for the taxable year 1981 with the Internal Revenue Service Center, Ogden, Utah.

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[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted.

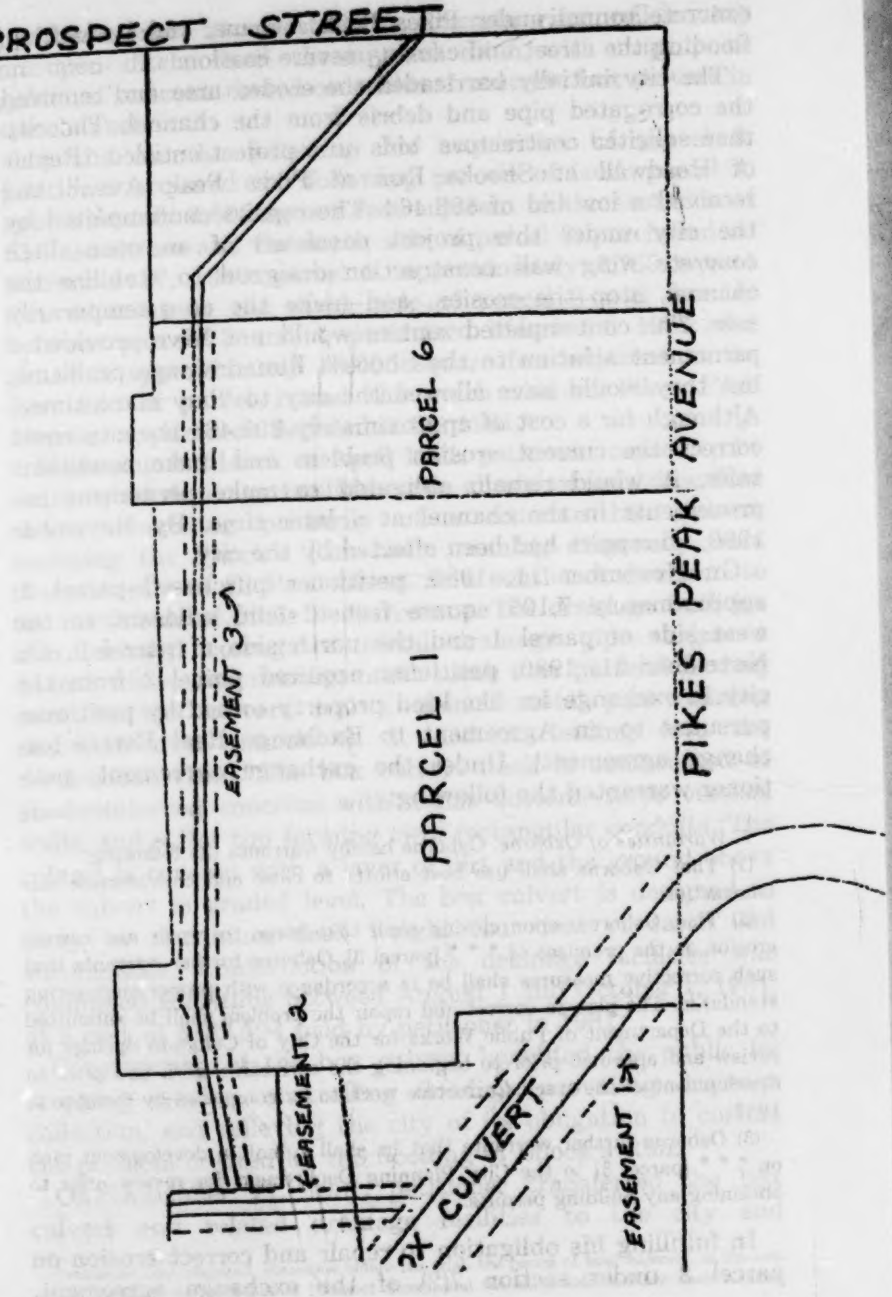
Petitioner Robert P. Osborne (hereinafter referred to as petitioner) is in the business of real estate development and construction contracting. In 1979, petitioner acquired for development the first of seven contiguous parcels of property constituting one-half city block located on Pikes Peak Avenue in Colorado Springs, Colorado, between El Paso and Prospect Streets. See the diagram on page 577.

Parcel 1, approximately 52,000 square feet of land and four small buildings, is situated on the north side of Pikes Peak Avenue and was acquired by petitioner on October 18, 1979. At that time, the City of Colorado Springs (city) owned parcel 3, a tract of land consisting of approximately 29,153 square feet adjacent to the west side of parcel 1, the north side of Pikes Peak Avenue and the east side of El Paso Street. The city had acquired parcel 3 in connection with a road construction project designed to link Pikes Peak Avenue to Colorado Avenue and create a major east-west arterial through Colorado Springs.

Running diagonally through parcel 3 and the corner of parcel 1 is Shook's Run, a natural ditch drainage system in Colorado Springs. For years the city had experienced problems with the Shook's Run drainage system, including bank stabilization, drainage control into the channel, and maintenance of the channel. Consequently, the city implemented the Shook's Run Project to improve Shook's Run by rehabilitating the channel, buying houses and removing them from the banks, and building parks and bicycle trails designed to clean up and stabilize the area.

Shook's Run, located in an older part of Colorado Springs, is exempt from the city's drainage regulations. Consequently, landowners have no obligation to build or pay for drainage facilities in Shook's Run. Rather, the city, through its Department of Public Works, is responsible for the safe discharge of waters within the Shook's Run drainage system.

In May 1980, a serious flood occurred causing erosion in the vicinity of Shook's Run over parcels 1 and 3. The flood waters came down Shook's Run basin, crumpled the corrugated metal pipe culvert lining the open ditch into the


PROSPECT STREET
PARCEL 6
PIKES PEAK AVENUE
EASEMENT 3
PARCEL 1
EASEMENT 2
EASEMENT 1
2X CULVERT

[illegible]

In fulfilling his obligation to repair and correct erosion on parcel 3 under section [illegible] of the exchange agreement, concrete tunnel under Pikes Peak Avenue, and backed up, flooding the street and causing severe erosion.

The city initially barricaded the eroded area and removed the corrugated pipe and debris from the channel. The city then solicited contractors' bids on a project entitled "Repair of Headwall at Shooks Run at Pikes Peak Ave.," and received a low bid of $93,464. The repairs contemplated by the city under this project consisted of an open ditch concrete wing wall construction designed to stabilize the channel, stop the erosion, and make the area temporarily safe. The contemplated repairs would not have provided a permanent solution to the Shook's Run drainage problems, but they would have allowed the city to "buy some time." Although for a cost of approximately $93,464 the city could correct the current erosion problem and make conditions safer, it would remain obligated to make permanent improvements in the channel at a later time. By November 1980, no repairs had been effected by the city.

On November 11, 1980, petitioner purchased parcel 2, approximately 7,105 square feet of land adjacent to the west side of parcel 1 and the north side of parcel 3. On November 21, 1980, petitioner acquired parcel 3 from the city in exchange for like kind property owned by petitioner pursuant to an Agreement to Exchange Real Estate (exchange agreement). Under the exchange agreement, petitioner warranted the following:

> 7. *Warranties of Osborne.* Osborne hereby warrants the following:
>
> (1) That Osborne shall use best efforts to close and consummate this transaction.
>
> (2) That Osborne, upon closing shall take steps to repair and correct erosion on the premises of * * * [parcel 3]. Osborne further warrants that such corrective measures shall be in accordance with proper engineering standards. The plan to correct and repair the problem shall be submitted to the Department of Public Works for the City of Colorado Springs for review and approval prior to beginning the corrective work and prior to development of the tract. Corrective work to be completed by October 1, 1981.
>
> (3) Osborne further warrants that he shall submit a development plan on * * * [parcel 3] to the City Planning Department for review prior to obtaining any building permits.

In fulfilling his obligation to repair and correct erosion on parcel 3 under section 7(2) of the exchange agreement, petitioner could have installed a concrete wing wall leaving an open ditch, lined the natural ditch with "riprap or gabions," or constructed an enclosed concrete box culvert in the channel.

In the months following his acquisition of parcel 3, petitioner acquired the following parcels of land: parcel 4, approximately 4,600 square feet adjacent to the east side of El Paso Street and the north side of parcel 3, purchased on December 17, 1980; parcel 5, approximately 2,700 square feet adjacent to the north side of parcel 3 and directly between parcels 2 and 4, purchased March 14, 1981; and parcel 6, approximately 18,000 square feet adjacent to the east side of parcel 1 and the north side of Pikes Peak Avenue, acquired on September 29, 1981.[2]

Beginning in March or April 1981, petitioner caused to be constructed drainage facilities over all six parcels described above, consisting primarily of a concrete box culvert enclosing the Shook's Run basin running diagonally from the east side of El Paso Street in a southeast direction to the north side of Pikes Peak Avenue. The drainage facilities also included corrugated metal drainage pipe tie-ins: a 54-inch metal pipe running north-south over parcel 2 feeding into the box culvert and a 48-inch metal pipe running east-west over parcels 6, 1, and 2, feeding into the north-south tie-in. The box culvert itself is constructed of steel-reinforced concrete with a flat bottom, three vertical walls, and a flat top forming twin rectangular conduits. The culvert is covered with a layer of dirt and the ground above the culvert is graded level. The box culvert is designed to carry as maximum dead weight four feet of earth and automobiles. Construction of the drainage facilities was completed sometime between August 1 and October 1, 1981, at a cost of $182,594 paid by petitioner in 1981.

Construction of the box culvert benefited the public by stopping erosion, controlling flooding, providing drainage collection, and relieving the city of its obligation to correct the problem created by the flooding of Shook's Run.

On December 21, 1981, petitioner transferred the box culvert and related drainage facilities to the city and granted it easements over all the ground through which the box culvert and related improvements ran. The city encouraged petitioner to make the transfers and grant the easements primarily to obtain "overall maintenance control" and to allow the city to "protect construction adjacent to the channel." In transferring the box culvert and granting the easements, petitioner was obligated to maintain the box culvert only for a 1-year warranty period. The box culvert has required no maintenance from the time of its installation up to the time of trial, and is not likely to require maintenance for a considerable number of years.

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[2] Petitioners also acquired, sometime before the trial, the parcel of land adjacent to the east side of parcel 6, the west side of Prospect Street, and the north side of Pikes Peak Avenue.

The fair market value of the assembled ground with the box culvert in place prior to the conveyance of the easement to the city was $5 per square foot, and the highest and best use for the property would have been for commercial real estate development for which it is zoned.

Petitioners' 1981 return reflects a "gift" to the city valued at $275,849 ($182,594 for the cost of the drainage facilities and $93,255 for the value of the easements). Petitioners claimed a deduction for a charitable contribution in the amount of $30,890 on their 1981 income tax return. The percentage limitation of section 170(b) limits the amount petitioners may have as a deduction for 1981 to that amount. Petitioner now concedes that $93,464 of the cost of constructing the drainage facilities ($182,594) is not deductible as a charitable contribution because it represents petitioner's performance under the exchange agreement.

OPINION

The issue for our decision is whether petitioners are entitled to a charitable contribution deduction under section 170[3] for the value of the drainage facilities transferred and easements granted to the City of Colorado Springs in 1981. Section 170(a) allows a deduction for any "charitable contribution." This includes, under subsection (c), a charitable contribution to a State or political subdivision thereof, provided the gift is made for "exclusively public purposes." The City of Colorado Springs qualifies as a political subdivision of a State, and we have found that the drainage facilities and easements, to the extent they constitute a contribution, were to be used for public purposes. The issue, therefore, is whether the installation and transfer of the drainage facilities and granting of the easement rights constituted a "charitable contribution" within the meaning of section 170.

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[3] SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) ALLOWANCE OF DEDUCTION.—

(1) GENERAL RULE.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

* * * * * * *

(c) CHARITABLE CONTRIBUTION DEFINED.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

The term "charitable contribution" is synonymous with the word "gift." *Sutton v. Commissioner*, 57 T.C. 239, 242 (1971); *DeJong v. Commissioner*, 36 T.C. 896, 899 (1961), affd. 309 F.2d 373 (9th Cir. 1962). "A gift is generally defined as a voluntary transfer of property by the owner to another without consideration therefor. If a payment proceeds primarily from the incentive of anticipated benefit to the payor beyond the satisfaction which flows from the performance of a generous act, it is not a gift." *DeJong v. Commissioner*, 36 T.C. at 899; *Bogardus v. Commissioner*, 302 U.S. 34, 41 (1937). "If the transfer is impelled primarily by the anticipation of some economic benefit or is in fact an exchange in the form of a substantial quid pro quo, it is not a contribution." *Rusoff v. Commissioner*, 65 T.C. 459, 469 (1975), affd. 556 F.2d 559 (2d Cir. 1977).

These principles have been applied in a variety of factual situations cited by respondent to deny charitable contribution deductions where taxpayers transferred property (1) pursuant to a contractual obligation or local ordinance, (2) in exchange for a zoning change or building permit, or (3) in exchange for a promise by the city to construct schools or widen roads. *Stubbs v. United States*, 428 F.2d 885, 887 (9th Cir. 1970); *Wolfe v. Commissioner*, 54 T.C. 1707 (1970).[4] See also *Sutton v. Commissioner*, 57 T.C. 239, 242 (1971); *Perlmutter v. Commissioner*, 45 T.C. 311 (1965).

Petitioner's situation, however, is not the usual one. Unlike the taxpayers in the cited cases, petitioner constructed and installed drainage facilities on his own property and transferred them to the city without legal or contractual compulsion; further, petitioner neither expected nor received from the city any significant action, promise, or permission in exchange for his transfer.[5] However, the construction of the box culvert, while serving a public purpose, enhanced the value of petitioner's property surrounding Shook's Run. We think petitioner's construction, installation, and transfer of the box culvert and related drainage facilities along with the easements, had a dual character and included both deductible and nondeductible elements. See *United States v. American Bar Endowment*, 477 U.S. ___, ___ (1986); *DeJong v. Commissioner*, 36 T.C. at 899-900; *Considine v. Commissioner*, 74 T.C. 955, 968 (1980).

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[4] *Dockery v. Commissioner*, T.C. Memo. 1978-63.

On the one hand, petitioner relieved the city of its then current obligation to correct erosion caused by flooding and to install correctional drainage facilities in Shook's Run.[6] In addition, by constructing a box culvert rather than an open wing wall or less permanent structure, petitioner relieved the city of its obligation to improve drainage facilities in Shook's Run for the indefinite future. Moreover, the city preferred the more expensive and long lasting box culvert type of facility and encouraged petitioner to transfer the improvements. The transfer of the drainage facilities and easements to the city gave the city maintenance control and allowed it to protect construction adjacent to the channel. Petitioner was not obligated under local ordinances to improve the drainage basin which ran through his land or to dedicate any portion of his property for the city to do so, and was at no time legally or contractually obligated to transfer the drainage facilities.

On the other hand, by installing a concrete box culvert, petitioner created new land over the Shook's Run channel and increased the value of his land surrounding the channel.

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[5] Respondent argues that in exchange for petitioner's easement grants, the city agreed to maintain the drainage facilities. This argument is considered in our discussion, *infra*.

[6] Respondent argues that petitioner's box culvert construction merely fulfilled his obligation to the city under the exchange agreement and was therefore not a gift. Petitioner has agreed that $93,464 of his expenditures represented his performance under that contract; however, we think petitioner exceeded his contractual obligation by installing a box culvert because his promise to repair and correct the erosion problem: (1) Could have been fulfilled through a less expensive and less permanent means, and (2) was limited to parcel 3.

The box culvert is completely encased in concrete and covered with earth to form a contiguous piece of land unlike a concrete wing wall or riprap lining which leaves an open ditch. Choosing the box culvert type of construction thus permitted petitioner to use this "new land" as a parking lot or landscaped area and improve the appearance and utility of his surrounding properties.

The cost of petitioner's improvements to his own land are not "direct economic benefits" bestowed on him directly or indirectly by the city (*Stubbs v. United States*, 428 F.2d at 887; *Sutton v. Commissioner*, 57 T.C. at 243), nor are they "incidental" in nature, as petitioner claims (*Myers v. United States*, 81-1 USTC par. 9179 (N.D. Ala. 1980); *Citizens & Southern National Bank of S.C. v. United States*, 243 F. Supp. 900, 906 (W.D. S.C. 1965)). Rather, they represent nondeductible capital expenditures incurred by petitioner to improve his property and as such must be added to his basis in the property. Sec. 263(a)(1); see *Mt. Morris Drive-In Theatre Co. v. Commissioner*, 238 F.2d 85, 86 (6th Cir. 1956), affg. per curiam 25 T.C. 272 (1955).

Therefore, to the extent petitioner improved his own property by installing the box culvert and related facilities, his expenditures must be capitalized; to the extent that petitioner gratuitously benefited the city by providing permanent rather than temporary drainage facilities in Shook's Run, and by conveying the easements, he is entitled to a charitable contribution deduction.

The easements over the installed drainage system facilitated the city's ingress and egress over the property to repair and maintain the system and gave the city more direct control over construction adjacent to the Shook's Run channel. Respondent argues that because the city agreed to maintain the drainage facilities after the first year, petitioner received a "quid pro quo" for his easement grants to the city. See *Singer Co. v. United States*, 196 Ct. Cl. 90, 449 F.2d 413, 423 (1971).

We disagree. First, petitioner was not looking to free himself of the obligation to maintain the facility. Rather, he granted the easements at the request of the city, which for its own reasons as a municipality desired to control the repair and maintenance of the drainage facilities. Second, as of the date of trial, the box culvert had required no maintenance and is not likely to require repairs or maintenance for years to come. Any benefit petitioner received as a result of the city's assumption of maintenance responsibilities was incidental. Therefore, petitioners' charitable contribution deduction must take into account the value of the easement rights granted to the city in 1981.

In determining the amount of the charitable contribution deduction, we must consider a number of factors including the city's obligation to provide safe drainage facilities in the Shook's Run basin; the value to the city of the discharge of this obligation for the indefinite future; the value to the city of obtaining the easements and ownership of the culvert and related facilities to enable it to control future repairs and maintenance; the value added to petitioner's land by the box culvert construction as compared with an open wing wall or other similar structure; the diminution in value attributable to petitioner's relinquishment and the city's ownership of the easements over the land; and other pertinent considerations.

To assist in making the required determination in this unusual factual situation, we have the benefit of the reports and testimony of three experts. Petitioner's expert, Frank J. Parisi (Parisi), values all of petitioner's land at $5 per square foot before the easements were granted and $3 per square foot for parcels 2, 3, 4, and 5 after the easements were conveyed, arriving at a value of $87,000 for the easements.[7]

The views of one of respondent's experts were so extreme as to be of little assistance. The report of T. Patrick Luna (Luna), however, contains a helpful analysis. Based on an examination of sales of comparable property, Luna's report shows that parcels 2, 3, 4, and 5, the part of petitioner's property directly affected by the easements, would have had a value of $1.80 to $2 per square foot improved only with a floodway ditch. After petitioner's improvements were made on these parcels and before the easements were granted, Luna's report places a value of $4.50 to $5 per square foot on the property. "Thus," his report states, "the value of the subject's remainder property lies within two extremes: (1) $1.80—$2.00/sq. ft. which represents an easement limiting any and all construction or use by the owner, and (2) $4.50 to $5.00/sq. ft. which represents the property unrestricted by any easement." Taking into account the use that could be made of the property covered by the easements, Luna reduced the value of these four parcels by $0.90 to $1 per square foot ($17,000 to $19,000) for the easements themselves plus a "severance effect to the remainder of the property" for an additional adjustment of $5,000 to $7,000. He defines "severance effect" as "the reduction in market value of the remainder parcel resulting" from the grant of the easements. On this basis he arrives at a value of $22,000 to $26,000. This analysis reflects both the increase in value of petitioner's land attributable to the improvements and the value of the easements.

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[7] Both petitioner's expert, Frank J. Parisi, and respondent's expert, T. Patrick Luna, agree that the easement which transverses the northern sections of parcels 1 and 6 has little or no effect on the value of those two parcels. The experts concentrated their analysis, therefore, on the diminution in value to petitioner's parcels 2, 3, 4, and 5 attributable to the grant of the easements. Based on the experts' reports and testimony, we find that the easements had little or no effect on the value or utility of parcels 1 and 6.

We are in basic agreement with Luna's approach to a determination of the amount of the allowable deduction. In our view, however, Luna understates the severance effect of the easements on the use of parcels 2, 3, 4, and 5. His testimony shows that he thought that a building could be constructed over the easements. While constructing such a building might be legally permissible, it would be impractical. Such a building, according to the testimony of other witnesses, would have to be so designed that the pilings or other foundation on which it rested would not adversely affect the underground drainage facilities. Further, any structure over the easements would be subject to removal if repair of the drainage facilities became necessary. As we view the evidence, the city would not likely grant a building permit for such a structure and, if it did, no lending institution would make a loan for financing a building constructed over the easements. Moreover, the easements cover a major portion of parcels 4 and 5 and leave the portions of parcels 2 and 3 not covered by the easements as irregularly shaped and disjointed tracts. For all practical purposes, parcels 2, 3, 4, and 5 could be used only for decorative landscaping, parking facilities, or some sort of temporary structure. Therefore, we think a more reasonable value for these four parcels with the improvements in place and the easements conveyed is the $3 per square foot figure reported by petitioner's expert, Parisi. This reflects a net benefit of $1 per square foot derived from the installation of the underground, as opposed to the open ditch, drainage facilities on those four parcels.

Taking into account the value the land would have had with an open ditch, the increase in value attributable to the box culvert, the effect of the grant of the easements, the excess expenditures incurred by petitioner for the underground installation, and all other relevant evidence, we find that petitioners are entitled to a total deduction of $45,000 for their contribution of the installed facilities and easements to the city.

Although our finding as to the amount of the charitable deduction is less than the total amount claimed, it exceeds the deduction allowable under section 170(b) for 1981. Accordingly,

Decision will be entered for the petitioners.

BLOOMINGTON TRANSMISSION SERVICES, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 13368-85, 39141-85. Filed September 4, 1986.

P, an Illinois corporation, was dissolved for failure to pay franchise tax and to file an annual report. Illinois law limited P's capacity to maintain a civil action, unless P remedied its failure to pay franchise tax and file annual report. P was required either to remedy the cause of dissolution or wind up its affairs during a 2-year period following dissolution, and P did neither. Thereafter, R issued a statutory notice of deficiency to P and P filed a petition with this Court. R moved to dismiss P for lack of capacity to maintain an action in this Court. This Court has held that Illinois dissolution statutes would preclude corporations from petitioning this Court. P contends that prior cases presented situations where the corporation was without assets and the shareholders would have their day in court when R sought to collect the tax in a transferee proceeding. P asserts that this case is different because dismissal of this case would result in

assessment and collection of the tax without a remedy and because the assets were held by the corporation. *Held*, the existence of assets in a dissolved corporation which may be the subject of collection or the reduced remedies or forums available to a dissolved corporation do not affect or modify the incapacity to initiate or maintain a civil action in the State of Illinois and hence in this Court within the meaning of Rule 60(c) of our Rules of Practice and Procedure.

David J. Duez, for the petitioner.
David R. Reid, for the respondent.

OPINION

GERBER, *Judge*: Respondent determined, by means of statutory notices dated February 14, 1985, and September 9, 1985, deficiencies in Federal income taxes and additions to tax for the taxable years ended November 30, 1979, 1980, 1981, and 1982. Petitioner, a corporation which had been dissolved by the Secretary of State of Illinois for failure to file annual reports and pay franchise tax, filed two timely petitions in response to respondent's notices. Respondent moved to dismiss both cases because of petitioner's lack of capacity to sue or be sued under Illinois law and to initiate or maintain a proceeding in this Court. The parties stipulated that petitioner was a de facto corporation under Illinois law at the time of filing its petitions.[1]

Petitioner was dissolved on December 1, 1977, and no action has been taken to reinstate retroactively its corporate status as a de jure corporation under the laws of the State of Illinois. Under chapter 32 of the Illinois Revised Statutes section 157.94 (effective July 1, 1933), petitioner was permitted 2 years from dissolution within which to commence the prosecution or defense of any actions or proceedings. Chapter 32 of the Illinois Revised Statutes was amended by section 12.80 (effective July 1, 1984) extending the period to 5 years instead of the 2 years originally permitted under section 157.94. Because the 5-year period would have run as of December 1, 1982, the 1984 change in

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[1] The parties have also stipulated that "In Illinois, the requisite elements for the existence of a *de facto* corporation are a valid law under which it may be organized; colorable or apparent compliance with the law; and a user of corporate powers."

Illinois law would not have cured petitioner's apparent impediment in this case.

Respondent brought an action, during 1984, against petitioner and its president, Robert A. Perschall, to enforce an Internal Revenue Service summons seeking petitioner's records. The summons was issued in connection with respondent's investigation of Robert Perschall (Perschall). Perschall asserted his Fifth Amendment priviledge against self-incrimination and argued that the privilege extended to petitioner because it had been dissolved and the records were therefore of a "sole proprietorship." See *United States v. Doe*, 465 U.S. 605 (1984).

Chief Judge Baker, by an order entered May 20, 1985, found that petitioner was "estopped from denying a corporate existence, despite its statutory dissolution. * * * *United States v. Harrison*, 653 F.2d 359, 361-362 (8th Cir. 1981)." *United States v. Bloomington Transmission Services, Inc.*, No. 84-3335 (C.D. Ill., May 20, 1985). Among his factual findings, Chief Judge Baker found that: (1) Petitioner continued to maintain a bank account and issue checks in its corporate name; (2) Federal and State corporate tax returns were filed for 1979 through 1981; and (3) petitioner was generally held out to be a business "entity with 'an independent institutional identity.'" Accordingly, petitioner was not permitted to deny its corporate existence for purposes of a summons enforcement proceeding where its records were sought and the District Court permitted enforcement, in part, under the rationale of *Bellis v. United States*, 417 U.S. 85 (1974).

Petitioner argues that the District Court order established its status as a de facto corporation which, under Illinois law would have authority to maintain actions, including this proceeding pursuant to Rule 60(c).[2] Petitioner cites three Illinois cases for the proposition that a de facto corporation, under "Illinois common law," has the ability to maintain and defend legal proceedings. Respondent agrees that petitioner is a de facto corporation and that petitioner has a corporate existence for some purposes. Respondent, however, argues that petitioner does not have the capacity to initiate a legal action.

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[2] Unless otherwise indicated, all Rule references are to this Court's Rules of Practice and Procedure, and all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

Rule 60(c) provides that a corporation's "capacity * * * to engage in * * * litigation [in this Court] shall be determined by the law under which it was organized." In the absence of notification by a fiduciary, section 6212(b)(1) permits respondent to issue a notice of deficiency to a corporation, even where its existence has been terminated. Furthermore, Illinois law would deny capacity to institute a legal proceeding to a corporation that failed to pay State franchise tax or file annual reports. *Padre Island Thunderbird, Inc. v. Commissioner*, 72 T.C. 391, 394-399 (1979); *Great Falls Bonding Agency, Inc. v. Commissioner*, 63 T.C. 304, 306-307 (1974). These facts present the seemingly anomalous situation where respondent may send a notice to a corporate taxpayer which may not exist or have capacity to petition this Court. *Padre Island Thunderbird, Inc. v. Commissioner, supra*; *Condo v. Commissioner*, 69 T.C. 149 (1977). We have considered this perceived anomaly and reasoned that even though we cannot consider the merits of respondent's determination, they may be questioned and litigated in a transferee liability proceeding if respondent looks to the assets in the hands of a former shareholder. *Great Falls Bonding Agency, Inc. v. Commissioner, supra* at 306-307. Our prior rationale, however, does not fully respond to petitioner's argument that prior cases have not presented the factual situation where, although dissolved, the corporate entity continues to operate and has assets which may be sufficient to satisfy the deficiency determined in respondent's notice. If a petition is dismissed for lack of a petitioner's capacity, respondent may assess the determined deficiencies. Thereafter, petitioner-corporation argues, it would not be able to defend itself from enforced collection of the assessed deficiencies because of its incapacity to sue under Illinois law.[3]

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[3] Although petitioner's argument assumes that the corporate entity would be the subject matter of respondent's collection activity, there is case precedent which could mitigate against petitioner's concerns and produce the transferee factual setting contemplated in *Great Falls Bonding Agency, Inc. v. Commissioner*, 63 T.C. 304, 306-307 (1974). The dissolution of a corporation generally does not terminate the rights of stockholders, and the property of the corporation may become vested in the stockholders. *Levy v. Liebling*, 238 F.2d 505, 507 (7th Cir. 1956), cert. denied 353 U.S. 936 (1957). This is particularly true in a situation, as presented herein, where the corporation is owned and operated by a single shareholder.

Petitioner, in this regard, contends that it "acquired separate *de facto* status apart from the corporation, *de jure* recognition provided" under Illinois statutory law. Further, petitioner argues that the District Court has already determined that petitioner has a corporate de facto status.

Corporations are creatures of statute and their existence and capacity are dependent upon the State law under which they were created. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819); *Chicago Title & Trust Co. v. Wilcox Bldg. Corp.*, 302 U.S. 120 (1937); *Chevron Oil Co. v. Clark*, 291 F. Supp. 552, 560-561 (S.D. Miss. 1968), affd. in part and revd. in part on other grounds 432 F.2d 280 (5th Cir. 1970) (applying Mississippi law). We have recognized that Illinois law effectively dissolves a corporation in violation of annual report and franchise tax payment requirements. Chapter 32 of the Illinois Revised Statutes section 157.82 (and its successor, section 12.35 of chapter 32 as enacted in Illinois Public Act 83-1025, effective July 1, 1984) permitted the secretary of state or attorney general of Illinois to dissolve judicially or administratively a corporation that has either failed to file its annual report or pay its franchise tax. Petitioner in this case was so dissolved for failing to file the report or pay the franchise tax.

In essence, chapter 32 of the Illinois Revised Statutes section 12.80 (effective July 1, 1984), and its predecessor section (chapter 32, section 157.94) provide for a 2- or 5-year period within which to reinstate corporate status by curing defects or otherwise to wind up its affairs (including the institution of a legal proceeding). These statutes place a clear and unambiguous limit upon a corporation's capacity and ability to institute or maintain a civil action in the State of Illinois unless the corporate status is restored by the remedy provided. To the extent discernable from the facts recited in our prior opinions, all of the taxpayer-corporations were either within the "winding-up period" or inactive and without assets from which respondent could collect the assessment attendant upon dismissal for lack of jurisdiction. Petitioner contends that the factual distinction of this case should provide a basis for us to consider it a de facto corporation with capacity to maintain this proceeding. We do not agree.

State statutes which provide a limited period to wind up following dissolution represent a valid and constitutional exercise of legislative power. *Chicago Title & Trust Co. v. Wilcox Bldg. Corp.*, *supra*. After the expiration of the time allowed for the winding up of a dissolved corporation, it generally cannot sue or be sued at law. *Levy v. Liebling*, 238 F.2d 505 (7th Cir. 1956), cert. denied 353 U.S. 936 (1957). Generally, a dissolved corporation will not be considered a de facto corporation, for corporation de facto status assumes or implies the ability to become a corporation de jure. *Clark v. American Cannel Coal Co.*, 165 Ind. 213, 73 N.E. 1083, 1084 (1905); *Rogers v. Toccoa Power Co.*, 161 Ga. 524, 131 S.E. 517, 520-522 (1926); 19 Am. Jur. 2d 664, sec. 2885 (1986). There is limited authority holding that a corporation which has lost its de jure status may, during its winding-up period, be both de jure and de facto. *Garzo v. Maid of the Mist Steamboat Co.*, 303 N.Y. 516, 104 N.E. 2d 882, 886-887 (1952). In *Garzo*, the court specifically qualifies its holding to the extent that the de facto status may not be questioned by anyone other than the State. This reasoning comports with the more general principle that the State may legislate the terms of corporate existence. To find in this case that petitioner had the capacity to sue beyond the statutory period for winding up following dissolution would frustrate, undermine, and ignore the authority of the State of Illinois to legislate and regulate the existence of a corporate entity.

We recognize that our holding will leave petitioner in the anomalous position of being unable to defend against the determination, assessment, and possibly the collection of Federal tax. It was, however, petitioner's shareholder-officer's failure to file annual reports or pay franchise tax, or to cure the defects during either the 2- or 5-year "winding-up period." Moreover, petitioner was operated beyond the clear legislative limit of its existence without statutory authority or color of corporate existence due to its inability to acquire again a de jure existence.[4]

Our holding is not inconsistent with the District Court's order estopping petitioner from denying corporate existence for purposes of a summons enforcement action seeking corporate records. The District Court has properly denied petitioner's attempt to use its failure to comply with State law to thwart the rights of others to whom petitioner was held out as a corporation.[5]

In view of the foregoing, we find, under the law of the State of Illinois, petitioner is without capacity to petition this Court for a redetermination of the two statutory notices of deficiency respondent issued. Respondent's motions to dismiss for lack of jurisdiction will be granted.

To reflect the foregoing,

Appropriate orders will be entered.

ESTATE OF ELMIRA S. BRANDES, DECEASED, ROBERT S. BRANDES, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 27513-84. Filed September 8, 1986.

In 1977, D entered into a contract to sell a farm to her son, S. The purchase price was to be paid in installments, and the title to the property was held in escrow pending completion of such payments. D died in 1980 before all of the payments were made. *Held*:

1. The value of D's rights under the contract of sale is includable in the estate; consequently, the estate is not entitled to value such rights as qualified real property under sec. 2032A, I.R.C. 1954.

2. Sec. 2036, I.R.C. 1954, is not applicable to the transfer of the farm since it constituted a bona fide sale for full consideration.

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[4] The parties' stipulation that petitioner is a de facto corporation under Illinois law is recognized for purposes of this case. Our holding is limited to petitioner's capacity to petition this Court. We make no findings with respect to petitioner's status for any other purpose.

[5] Petitioner has argued both that it exists and does not exist, depending upon which position is most advantageous at the time. Being estopped from using petitioner's impaired status to its own advantage or to the detriment of others is not the same as a determination that petitioner was a de facto corporation for all purposes, including capacity to sue.

Emmanuel F. Guyon, for the petitioner.
Lauren W. Gore, for the respondent.

OPINION

SIMPSON, *Judge*: The Commissioner determined a deficiency of $14,630.57 in the estate tax of the petitioner. The issues for decision are: (1) Whether an estate can value a farm under section 2032A of the Internal Revenue Code of 1954[1] with respect to which the decedent had entered into a contract of sale; and (2) whether section 2036 is applicable to such sale.

All of the facts have been stipulated, and those facts are so found.

Elmira S. Brandes (the decedent) died on December 12, 1980. Her son, Robert E. Brandes, was her sole surviving heir and has been appointed the executor of her estate; he maintained his legal residence in Streator, Illinois, at the time of the filing of the petition in this case. A Federal estate tax return was filed for the estate with the Internal Revenue Service Center, Kansas City, Missouri.

Prior to December 28, 1977, the decedent owned two parcels of land, each consisting of 80 acres, and described as "the East half of the Northeast quarter of section 11" (the East half) and "the West half of the Northwest quarter of section 12" (the West half), both in Otter Creek Township, LaSalle County, Illiniois. The parcels were used as a farm. At that time, the decedent was ill, and the income from the farms was insufficient for her medical care and other purposes.

The East half was appraised at a fair market value of $140,000 on June 1, 1977. On December 28, 1977, the decedent entered into a contract to sell the East half to her son for $140,000. A downpayment of $25,000 was payable on the execution of the contract, and the remainder was payable in annual installments of $11,850 commencing in 1978 and continuing for 15 years. Each installment included interest at the rate of 6 percent per annum. The decedent executed a deed transferring title to the East half and delivered it into escrow to be held by the escrow agent until the payment of the final installment under the contract. Mr. Brandes made the downpayment and paid three of the installments before the death of the decedent; the remaining balance due at her death was $99,241.18.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

The contract provided that Mr. Brandes was to receive possession of the East half on March 1, 1978. The 1977 crops were to be retained by the decedent, and she was to pay the 1977 taxes, which would be due in 1978. The contract also provided that Mr. Brandes would pay the taxes for 1978 and all subsequent years, and he was to receive the crops for 1978 and thereafter.

The decedent resided on the farms until several years before her death, when she moved to a nearby town. During those last several years, both the East half and the West half farms were leased to a nephew who operated the farms on a crop-share basis. At the date of her death, the decedent continued to own the West half.

A Federal income tax return was filed for the decedent for 1980. On that return, $6,288.18 was reported as interest on a "personal note Robert Brandes," and $5,282 was reported as farm income. No deductions were itemized.

On the estate tax return filed for the estate of the decedent, both the West half and the East half properties were reported.[2] The parties agree that the fair market value of the West half at the date of the decedent's death was $192,000 and that the special use valuation, computed in accordance with section 2032A, of such property at such time was $59,000. The return reported that the East half property had been sold and that $99,241.18 remained payable under the contract. However, the return claimed that the decedent had a retained life estate in the property and that under section 2036 the value of the property was includable in the estate. Accordingly, the return claimed that such property was also subject to the special use valuation under section 2032A and reported such property as having a value of $59,000. Nevertheless, the election for special use valuation under section 2032A and the agreement required by such section were filed only with respect to the West half property.

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[2] On the return, the properties were confused: the West half property was reported as sold to Mr. Brandes, but the entire record makes clear that it was the East half property which was sold.

In the notice of deficiency, the Commissioner determined that the estate was not entitled to use a special use valuation for the East half because the property had been sold; he determined that the amount remaining due under the contract was includable in the estate.

We must decide whether the decedent's interest in the East half farm is eligible for the special use valuation under section 2032A. That section allows an estate to elect to use a special method for valuing qualified real property which is used as a farm or in a closely held business. Under the special method, the value of the property is based on its use in the farm or business, rather than on the market value. The purpose of section 2032A is to enable families to continue to use the property as a farm or other business, and not to be compelled to sell it to pay the taxes. H. Rept. 94-1380 (1976), 1976-3 C.B. (Vol. 3) 735, 741.

Qualified real property is defined by section 2032A(b), insofar as here relevant, as:

> real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, * * *

The estate presents a variety of arguments in support of its position that the estate can include the value of the East half farm, computed under section 2032A, and not the value of the rights under the contract of sale between the decedent and Mr. Brandes. First, the estate argues that under Illinois law, a vendor retains legal title until there is a conveyance sufficient to transfer title and that there was no such conveyance in this case. The estate also urges us to ignore or set aside the contract. It contends that the decedent continued to have all of the incidents of ownership: she retained legal title to the property; she retained all crop proceeds; she made all decisions regarding the management of the farms, including the decisions as to planting, fertilizing, seed, crop rotation, and other matters; she paid the real estate taxes; and she dealt with the tenant. The estate takes the position that under these circumstances, there was a breach of the contract of sale by the decedent, that such breach operated to rescind the contract, and that the breach should cause the Court to apply "reverse equitable conversion." The estate has the burden of proving the allegations on which it relies. Rule 142(a), Tax Court Rules of Practice and Procedure; *Welch v. Helvering*, 290 U.S. 111 (1933).

In our opinion, the estate has failed to prove its factual allegations. The contract of sale provided that the decedent was to deliver possession of the East half farm to Mr. Brandes in 1978, that he was entitled to the crops for that and subsequent years, and that he was to pay the taxes for 1978 and subsequent years. The estate claims that these provisions of the contract were not carried out, but it has failed to present sufficient evidence to prove its claims. There is absolutely no evidence as to who paid the taxes on the farm for 1978 and later years. In the income tax return filed for the decedent for 1980, there was no claim of a deduction for taxes; in fact, deductions were not itemized, and the failure to claim the deduction for taxes may be explained by such circumstance. Nevertheless, the estate has presented no evidence showing that taxes were in fact paid by the decedent.

Mr. Brandes stated that, despite the contract of sale, the decedent marketed the crops and participated in the management of the farm. However, we do not know who received the proceeds from the marketing of the crops. It must also be remembered that the decedent continued to own the West half farm, and her participation in the management and her alleged dealings with the tenant may have related to her ownership of that farm. Similarly, farm income was reported on the 1980 return for the decedent, but that income may have been earned by the West half farm. The evidence is simply insufficient for us to conclude that there was a breach of the contract of sale.

Moreover, we cannot ignore or set aside that contract. In *Commissioner v. Union Pac. R. Co.*, 86 F.2d 637, 639 (2d Cir. 1936), affg. 32 B.T.A. 383 (1935), the court had to decide when a sale took place; the court stated the rule to be:

> A closed transaction for tax purposes results from a contract of sale which is absolute and unconditional on the part of the seller to deliver to

> the buyer a deed upon payment of the consideration and by which the purchaser secures immediate possession and exercises all the rights of ownership. * * *

See also *Ennis v. Commissioner*, 17 T.C. 465 (1951). Here, a contract of sale was executed in 1977, and the deed was also executed and transferred into escrow. A downpayment was made, and so far as we know, possession was delivered in 1978 to the purchaser. Under these circumstances, there was a sale of the property, for Federal tax purposes, in 1978. As a result of that sale, the decedent's interests changed: she no longer owned the East half farm, but she had a contract giving her certain rights.

> Thus, when the vendor dies while the contract is subsisting and specifically enforceable by and against him, his executor or administrator becomes entitled to the unpaid purchase money for the benefit of the legatees or next-of-kin; and if the purchaser fails to complete and the contract is not specifically enforced against him, the vendor's executor or administrator can enforce payment of this money out of the land in the hands of the vendor's devisee or heir. * * * [3 American Law of Property, sec. 11.23, at 65 (1952); fn. ref. omitted.]

If there was a breach of the contract, Mr. Brandes may have had a right to certain remedies, including the possibility of having the contract rescinded, but there is no evidence that he ever exercised any such right. See *Izzo v. City of Loves Park*, 20 Ill. App. 2d 117, 155 N.E.2d 312 (1959). Thus, at the time of the decedent's death, she did not own the East half farm, but she had a right to receive the payments under the contract of sale. The value of those payments, not the value of the farm, is includable in her estate. *Estate of Buckwalter v. Commissioner*, 46 T.C. 805 (1966).

The estate also argues that Congress intended for section 2032A to be applicable when the value of a farm is only indirectly includable in an estate. H. Rept. 94-1380, *supra*, 1976-3 C.B. (Vol. 3) at 758. However, in this case, it is not the value of the East half which is includable in the estate, directly or indirectly; it is the value of the decedent's rights under the contract of sale which is includable. The price for the farm represented its value, but she had received substantial payments under the contract before her death. In this case, it happens that the remaining payments under the contract exceeded the special use valuation. However, if she had received more of the installments before her death, the balance due under the contract might be less than the special use valuation, and in that event, it would be clear that only the value of the contract payments should be includable in the estate, not the special use valuation of the farm.

The estate also suggests that, after the decedent's death, there was a merger of the contract of sale, thereby extinguishing any right under that contract. However, the value of the rights under the contract is includable in the estate, even though the obligation under the contract is extinguished after the decedent's death. Sec. 20.2033-1(b), Estate Tax Regs.; *Estate of Buckwalter v. Commissioner, supra.* Thus, even if Mr. Brandes is not required to complete the installment payments under the contract because he is the beneficiary under the will, the value of the rights under the contract is nevertheless includable in the estate.

Finally, the estate maintains that we should set aside the contract of sale because section 2036 is applicable to the transfer. Under that section, property is includable in an estate where the decedent transferred the property during his lifetime but retained a life estate or certain other rights to it. However, section 2036 is not applicable to "a bona fide sale for an adequate and full consideration in money or money's worth." In this case, there was an appraisal of the East half farm within a few months before the contract of sale, and the farm was sold for the appraised value. Under such circumstances, we are satisfied that the sale to Mr. Brandes was a bona fide sale for full consideration to which section 2036 is not applicable. Consequently, we hold that the value of the remaining payments under the contract of sale is includable in the estate and that such value cannot be determined under section 2032A.

Decision will be entered for the respondent.

ESTATE OF JOHN RUSSELL LITTLE, DECEASED, CROCKER NATIONAL BANK, EXECUTOR, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 34590-83. Filed September 11, 1986.

Decedent possessed at the time of his death a power to invade, for his benefit, income and corpus of a trust. The power was limited to the standard that the invasion be for decedent's "proper support, maintenance, welfare, health and general happiness in the manner to which he is accustomed at the time of the death of [his wife]." ***Held*****: The power is not excepted from the definition of general power of appointment under sec. 2041(b)(1)(A), I.R.C. 1954, because the standard which limits the power does not relate solely to the health, education, support, or maintenance of decedent. Respondent's determination is sustained.**

Neil F. Horton, for the petitioner.
William E. Bonano, for the respondent.

OPINION

FAY, *Judge*: Respondent determined a deficiency of $191,087 in the Federal estate tax of the Estate of John Russell Little. The only issue is whether the value of assets of a trust of which John Russell Little was a beneficiary and the sole trustee is includable in his estate under section 2041.[1]

This case has been submitted under Rule 122. All of the facts have been stipulated and are found accordingly.[2]

Petitioner Crocker National Bank is the executor of the Estate of John Russell Little. Petitioner's principal office was located in San Francisco, California, when the petition herein was filed. The Federal estate tax return here involved was filed with the District Director of Internal Revenue, San Francisco, California.

John Russell Little (hereinafter sometimes referred to as decedent) died on August 2, 1979. At the time of his death, he was a beneficiary and the sole trustee of a testamentary trust (hereinafter sometimes referred to as trust) created by the will of his wife, Grace Schaffer Little (hereinafter sometimes referred to as Mrs. Little), who died on November 11, 1971. The pertinent provisions of the trust are as follows:

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect at the time of decedent's death, unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

[2] The stipulations and the exhibits attached thereto are incorporated herein by this reference.

> During the lifetime of John Russell Little, the trustee shall pay to or apply for the benefit of John Russell Little, so much of income and principal of the trust estate as is necessary, in the discretion of the Trustee after taking into consideration to the extent the Trustee deems advisable, other resources of John Russell Little available to him outside of this trust, for his proper support, maintenance, welfare, health and general happiness in the manner to which he is accustomed at the time of the death of Grace Schaffer Little.

Decedent's gross estate, as computed on his estate's Federal estate tax return, did not include the value of the trust's assets, which the parties agree was $539,088.01 at the time of decedent's death. Respondent determined an estate tax deficiency of $191,087 after including the value of the trust's assets in decedent's estate under section 2041.[3]

Under the three paragraphs of section 2041(a), the value of property is included in a decedent's gross estate in three distinct situations. Since we hold that the value of the trust's assets are included in decedent's gross estate under section 2041(a)(2), we do not consider whether a like result would obtain under section 2041(a)(1) or section 2041(a)(3).

Section 2041(a)(2) states in relevant part, "The value of the gross estate shall include the value of all property * * * [t]o the extent of any property with respect to which the decedent has at the time of his death a general power of appointment." Section 2041(b)(1) defines general power of appointment as a "power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." Section 2041(b)(1)(A) excepts powers which are "limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent."[4]

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[3] Because Mrs. Little died less than 10 years before decedent's death and the value of the trust's assets was included in her estate, upon including the value of the trust's assets in decedent's estate, respondent allowed it an increase in the sec. 2013 prior transfers credit. The $191,087 deficiency reflects this increase in the sec. 2013 prior transfers credit.

For the section 2041(b)(1)(A) exception to apply, the power of appointment must be limited to a standard that meets two requirements. The standard must be ascertainable and the standard must relate to the decedent's health, education, support, or maintenance. *Estate of Sowell v. Commissioner*, 74 T.C. 1001, 1003 (1980), revd. on other grounds 708 F.2d 1564 (10th Cir. 1983).

Unless the section 2041(b)(1)(A) exception applies, the power held by decedent as sole trustee of the trust to invade income and corpus for his benefit is clearly a general power of appointment. We therefore must determine if the standard of "proper support, maintenance, welfare, health, and general happiness in the manner to which [decedent] is accustomed at the time of the death of [Mrs. Little]" is an ascertainable standard relating solely to the health, education, support, or maintenance of decedent.[5]

We look to State law to determine whether the standard relates solely to the health, education, support, or maintenance of the decedent. See *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940); *De Oliveira v. United States*, 767 F.2d 1344, 1347 (9th Cir. 1985). Since Mrs. Little was a resident of California at the time of her death, California State law applies to the construction of the power held by decedent which was created by Mrs. Little's will. *De Oliveira v. United States*, *supra* at 1347; *Estate of Stober*, 108 Cal. App. 3d 591, 166 Cal. Rptr. 628 (1980).

Petitioner argues that a California State court construing the standard would "limit it to refer to the the standard of *support* which the decedent enjoyed at the time of his wife's death." (Emphasis added.) Petitioner refers to Cal. Civ. Code sec. 2269 and *In re Estate of Smith*, 117 Cal. App. 3d 511, 172 Cal. Rptr. 788 (1981). Petitioner suggests that we consider the language of Cal. Civ. Code sec. 2269 (West 1985) as substantially amended subsequent to decedent's death. Since section 2041(a)(2) refers to powers held by decedent "at the time of his death," we consider the language of section 2269 of the California Civil Code as enacted in 1872 and in effect at the time of decedent's death.[6] This version of the statute does not support petitioner's contention.

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[4] Sec. 2041(b)(1)(B) and (C) also are exceptions to the definition of general power of appointment. However, both apply to powers exercisable by a "decedent only in conjunction with another person" and, accordingly, are not here applicable as the decedent was the sole trustee of the trust.

[5] Although sec. 2041(b)(1)(A) does not contain the word "solely," the statute must be construed as if it contained that word. Failure to so interpret sec. 2041(b)(1)(A) would obviate words chosen by Congress. See *Matut v. Commissioner*, 86 T.C. 686 (1986); *Estate of Roy v. Commissioner*, 54 T.C. 1317, 1323 (1970).

In re Estate of Smith, 172 Cal. Rptr. at 790, in dicta, construed the following standard: "reasonable care, comfort, support and maintenance in accordance with the standard of living as of the date of [the trustor's] death." Relying heavily on the language "in accordance with the standard of living as of the date of [the trustor's] death" the court held that the standard was ascertainable.[7] Although the standard employed by the trust contains similar language, neither that language nor *In re Estate of Smith* supports petitioner's contention, as both are relevant only to whether the standard is ascertainable, an issue which we do not decide.[8] See note 12 *infra*.

Having rejected petitioner's contention, we now consider whether a California State court would interpret the standard employed by the trust to relate solely to the health, education, support, or maintenance of decedent. Our research of California State law, as aided by the parties, has not revealed any case directly on point. Therefore, we will consider the general rule of construing testamentary trusts under California State law. "A trust created by will is properly controlled by the expressed intention of the testatrix [and] the particular language used is always important." *In re Miller's Estate*, 230 Cal. App. 2d 888, 41 Cal. Rptr. 410, 422 (1964). "A trustee must * * * follow all the directions of the trustor." Cal. Civ. Code sec. 2258 (West 1985).[9]

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[6] Sec. 2269 of the California Civil Code, as enacted in 1872 and in effect at the time of decedent's death, which is reprinted in the Historical Note to Cal. Civ. Code sec. 2269 (West 1985), stated as follows:

"Discretionary powers. A discretionary power conferred upon a trustee is presumed not to be left to his arbitrary discretion, but may be controlled by the proper Court if not reasonably exercised, unless an absolute discretion is clearly conferred by the declaration of trust."

[7] "A power to invade corpus to provide for a beneficiary's 'reasonable care, comfort, support and maintenance in accordance with the standard of living as of the date of decedent's death' creates a far more *ascertainable* standard than several approved in the regulation." *In re Estate of Smith*, 117 Cal. App. 3d 511, 172 Cal. Rptr. 788, 794 (1981). (Emphasis supplied.) This statement and, more importantly, the lack of others discussing health, education, support, or maintenance lead us to the conclusion that *In re Estate of Smith* decided only that the standard was ascertainable.

[8] We envision only one situation in which the language referred to would affect whether the standard related solely to decedent's health, education, support, or maintenance. It may have been that decedent enjoyed no "general happiness" or "welfare" at the time of Mrs. Little's death. In such a case, the terms "general happiness" and "welfare" can be read out of the will as they refer to nothing. Even if petitioner had made such an argument before this Court, it would lose, as it has not proven that decedent's "general happiness" and "welfare" were nonexistent at the time of Mrs. Little's death. See Rules 142(a), 122(b), and 149(b).

We are convinced that a California State court properly applying these general rules would recognize that the standard employed by the trust does not relate solely to the health, education, support, or maintenance of the decedent. "Were [it] confronted with a dispute between the widow[er] and the remaindermen over the propriety of an invasion, [it] would not adopt a grudging and narrow interpretation of [general happiness]."[10] *In re Estate of Nunn*, 112 Cal. Rptr. 199, 204, 518 P. 2d 1151 (1974) (using the quoted language to interpret "need"); *Estate of Allgeyer*, 60 Cal. App. 3d 169, 129 Cal. Rptr. 820, 823 (1976) (using the quoted language to interpret "comfort").

We are convinced that a California State court would recognize that there are items which fall within the ambit of "general happiness," but which do not fall within the ambit of "health, education, support, or maintenance." Consider, for example, "travel." The California State Supreme Court has intimated that "travel" does not relate to "support, maintenance, or education."[11] *In re Estate of Nunn*, 112 Cal. Rptr. at 205. If it were necessary for decedent to travel to maintain the level of general happiness he enjoyed prior to his wife's death, he could invade the income and corpus of the trust to pay for such travel. Such an invasion is within the expressed intent of Mrs. Little: "the trustee shall pay to or apply for the benefit of [decedent], so much of income and principal * * * as is necessary * * * for his * * * general happiness in the manner to which he is accustomed at the time of the death of [Mrs. Little]." See *In re Miller's Estate*, *supra*; Cal. Civ. Code sec. 2258 (West 1985).

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[9] See also Cal. Prob. Code sec. 102 (West 1956), repealed for decedents dying after Dec. 31, 1984, 198 Cal. Stat. 842 and Cal. Prob. Code secs. 6103 and 6160 (West 1986 Supp.), which states in relevant part, "The words of a will are to receive an interpretation which will give to every expression some effect rather than one which will render any of the expressions inoperative."

[10] We, are aware that this Court has stated that a "word, such as 'happiness' " should be construed in the context in which it appears. *Estate of Ford v. Commissioner*, 53 T.C. 114, 126 (1969), affd. 450 F.2d 878 (2d Cir. 1971). We do not construe general happiness in isolation. However, the only language in the trust which limits the term is, "in the manner to which he is accustomed at the time of the death of [Mrs. Little]." We have already determined that this language, with one exception (see note 8 *supra*), relates only to whether the standard is ascertainable. Accordingly, we find no language in the trust which limits the term "general happiness" as it relates to our present discussion of whether the term is broader than health, education, support, or maintenance.

We do not find it necessary for the disposition of this case to construe "welfare." However, we note that "welfare" has, in the past, been construed to be broader than health, education, support, or maintenance. *Estate of Jones v. Commissioner*, 56 T.C. 35 (1971), affd. 474 F.2d 1338 (3d Cir. 1973) (construed under New Jersey State law); *Franz v. United States*, an unreported case (E.D. Ky. 1977, 39 AFTR 2d 1658, 77-1 USTC par. 13,182) (construed under Kentucky State law).

[11] The court does not refer to "health," but we readily note that "travel" often does not relate to the health of the traveler, the two being, for the most part, independent of one another.

"Travel" is not the only example of a proper use of the assets of the trust that would not be proper if the power to invade was limited solely to decedent's health, education, support, or maintenance. A listing of other examples is not here necessary. That one exists is sufficient to show that the standard employed by the trust does not relate solely to decedent's health, education, support, or maintenance. Accordingly, we hold that the section 2041(b)(1)(A) exception to the definition of general power of appointment is not here applicable.[12]

Since none of the exceptions to general power of appointment apply,[13] we hold that decedent possessed, at the time of his death, a general power of appointment. The power of appointment was exercisable over the income and corpus of the trust. Respondent was therefore correct in including the value of the trust's assets in decedent's gross estate. Sec. 2041(a)(2).

Decision will be entered for the respondent.

Further, we note, as we feel the California State Supreme Court would, that "travel" might, in some situations, relate to "support, maintenance, or education," though, for the most part, "travel" is independent of "support, maintenance, or education."

[12] We need not consider whether the standard is ascertainable as our holding that the standard is not related solely to the health, education, support, or maintenance of the decedent is dispositive of the applicability of sec. 2041(b)(1)(A).

In *Brantingham v. United States*, 631 F.2d 542 (7th Cir. 1980), the Court of Appeals for the Seventh Circuit held that a power to invade for decedent's "maintenance, comfort, and happiness" was, under Massachusetts State law, limited by an ascertainable standard. It further held that the sec. 2041(b)(1)(A) exception was applicable, although it did not address the issue determined in this opinion.

[13] See note 4 *supra*.

JAMES M. FOLEY, JR., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5384-83. Filed September 17, 1986.

Petitioner, a U.S. citizen, resided and worked in West Berlin, Germany. He received incentive payments pursuant to art. 28 of the Berlin Promotion Law. *Held*, petitioner properly computed his foreign tax credit, for U.S. income tax purposes, without taking such payments into account. *Held, further*, such incentive payments are includable in income under sec. 61, I.R.C. 1954.

John S. Yohanan, for the petitioner.
Milton Blouke, for the respondent.

OPINION

JACOBS, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes:

Taxable year	*Deficiency*
1978	$750
1979	6,854
1980	4,563

This case was submitted pursuant to Rule 122.[1] Pursuant to the Court's direction, a supplemental stipulation of facts was filed. At the time the supplemental stipulation of facts was filed, the Court permitted respondent to file an amendment to answer seeking additional deficiencies for 1978, 1979, and 1980 in the amounts of $1,254, $77, and $2,646, respectively, making the total amount in controversy $2,004 for 1978, $6,931 for 1979, and $7,209 for 1980.

The sole issue for decision is the proper treatment, for tax purposes, of payments made to petitioner, a citizen of the United States, pursuant to the Berlin Promotion Law.

Petitioner, a pilot employed by Pan American World Airways, Inc. (Pan Am), resided in West Berlin, Federal Republic of Germany (Germany), from August, 1978 through and including the time he filed his petition.[2] During the taxable years in issue, he had foreign source income, earned while stationed in West Berlin, and paid German income taxes, through wage withholdings, at a flat rate of 26 percent.

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954 as amended and as in effect during the taxable years in issue.

[2] From Jan. 1, 1978, to Aug. 9, 1978, petitioner resided in Incline Village, Nevada.

Petitioner received incentive payments of $2,068, $6,931, and $7,209, in 1978, 1979 and 1980, respectively, pursuant to Berlinfoerderungsgesetz (the Berlin Promotion Law).[3] Pursuant to articles 21 and 28 of the Berlin Promotion Law, benefits are offered to two categories of individuals: those who reside in West Berlin, and those who work there. The benefit offered to individuals who reside in West Berlin is a 30 percent reduction in German income taxes, pursuant to article 21. The benefit offered to individuals who work in West Berlin is an incentive payment pursuant to article 28.[4]

The two benefits (tax reduction and incentive pay) are not cumulative; the tax reduction is granted only to the extent it exceeds the incentive pay. The incentive pay is not includable in income for purposes of German income tax laws.

The treaty between the United States and Germany (the treaty) pertaining to tax matters[5] contains the following provisions:

> Article X
>
> (1) Compensation for labor or personal services (including compensation derived from the practice of a liberal profession and the rendering of services as a director) performed outside the United States by a natural person resident in the Federal Republic shall be exempt from tax by the United States.
>
> * * * * * * *
>
> Article XV
>
> (1) It is agreed that double taxation shall be avoided in the following manner:
>
> (a) The United States, in determining United States tax in the case of its citizens, residents or corporations, may, regardless of any other provision of this Convention, include in the basis upon which such tax is imposed all items of income taxable under the revenue laws of the United States as if this Convention had not come into effect. The United States shall,

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[3] Berlinfoerderungsgesetz of 23 February 1982, BGBI 1982 I p. 225, as amended by the Law of 20 December 1982, BGBI 1982 I p. 1828.

[4] The incentive payment is equal to 8 percent of income earned in West Berlin.

[5] T.I.A.S. 3133, 5 U.S.T. 2768, 1955-1 C.B. 635, as amended T.I.A.S. 5920, 16 U.S.T. 1883, 1885-1886, 1966-1 C.B. 360.

however, allow to a citizen, resident or corporation of the United States as a credit against United States tax the appropriate amount of Federal Republic tax paid, other than the Vermögensteuer (capital tax) and that portion of the Gewerbesteuer (trade tax) computed on a basis other than profits. Such appropriate amount shall be based upon the amount of Federal Republic tax paid but shall not exceed that portion of the United States tax which net income from sources within the Federal Republic bears to the entire net income. It is agreed, that, by virtue of the provisions of this Article, the Federal Republic satisfies the similar credit requirement of the Internal Revenue Code with respect to Federal Republic tax.

Petitioner did not report the incentive payments he received pursuant to the Berlin Promotion Law in his 1978, 1979, and 1980 U.S. income tax returns. He calculated the foreign tax credit allowable by section 901[6] by taking into account all taxes paid to the German government through wage withholdings.

Respondent contends that the incentive payments received by petitioner are includible in gross income under section 61, or in the alternative, that the incentive payments reduce petitioner's allowable foreign tax credit.[7]

Petitioner concedes that section 61 was intended by Congress to include in the U.S. tax base all income "from whatever source derived." He argues, however, that the incentive payments received are excludible from his U.S. income pursuant to the terms of the Berlin Promotion Law and the Treaty. Alternatively, he argues that the incentive payments were gifts, and thus excludible from his U.S. income either pursuant to section 102(a) or as payments made by a governmental unit to promote the general welfare. Petitioner does not make any argument pertaining to respondent's proposed adjustment to his foreign tax credit.

Petitioner's incentive payment under article 28[8] was slightly more than the tax reduction to which he was entitled under article 21[9]; therefore, none of the amounts received by petitioner was in discharge of the article 21 benefit. As petitioner did not receive any reduction o rebate of the taxes he paid to the German government, h properly calculated his foreign tax credit by taking all taxe paid to the German government into account. We must stil decide, however, whether petitioner should have included i income the incentive payments he received from the German government under article 28.

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[6] The amount of tax paid to the German Government in 1978, 1979, and 1980 was $6,721, $22,527, and $23,429, respectively.

[7] This alternative argument was first raised in respondent's amendment to answer, thus respondent bears the burden of proof with respect to such argument. Rule 142(a).

[8] The incentive payments amount to $2,068 in 1978, $6,931 in 1979, and $7,209 in 1980; these are the amounts petitioner actually received.

[9] The tax reduction would have been $2,017 in 1978, $6,758 in 1979, and $7,029 in 1980.

Neither the treaty nor the Berlin Promotion Law assist us in properly analyzing the consequences of the payment for purposes of U.S. income tax laws. Because amount received pursuant to the Berlin Promotion Law are no includable in income for purposes of computing tax liabilit to Germany, article XV of the treaty, which is designed t prevent double taxation, does not apply.[10] Because payments received pursuant to the Berlin Promotion Law ar not compensation for services, article X of the treaty, whicl exempts such payments from tax by the United States, als does not apply. The tax liability of petitioner, as a citizen o the United States, is determined by the provisions of th Internal Revenue Code. Sec. 1.1(b), Income Tax Regs.

Section 61 contemplates a tax on all income "fron whatever source derived"; there is no doubt that the U.S taxes its citizens on their worldwide incomes. *Filler v Commissioner*, 74 T.C. 406 (1980); *Crerar v. Commissioner* 26 T.C. 702 (1956). "Income" means accessions to wealth clearly realized, over which a taxpayer has complete dominion. Section 61 is intended to tax all gains, except thos specifically exempted. *Commissioner v. Glenshaw Glass Co.* 348 U.S. 426 (1955).

Petitioner argues that section 102 specifically exempt the amounts he received from the German Governmen from taxation. In order to determine whether the transfer to petitioner were gifts within the meaning of section 102 we must examine the motives of the German Government the putative donor, in making such transfers. A transfer, i order to be a gift, must be made from a detached anc disinterested generosity, out of affection, respect, admiration, charity or like impulses. *Commissioner v. Duberstein*, 363 U.S. 278 (1960). There is no gift where a payment is made in anticipation of future economic benefits.

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[10] Petitioner argues that because (1) the Berlin Promotion Law provides that the incentive are not earnings subject to German taxation, (2) the Berlin Promotion Law was adopted i toto by the City Council of West Berlin and (3) the city of West Berlin is governed by th Joint Allied Command, which in turn is subject to the approval of the U.S. Congress, it can b inferred that Congress has given implied approval to exemption of incentive payments unde the Berlin Promotion Law from U.S. income taxation. We find this argument creative, bu unpersuasive, and we reject it.

Petitioner's relationship with the German government is not one that is characterized by such affection, respect or disinterested generosity that the German government would make payments to petitioner without expecting anything in return. On the contrary, the Berlin Promotion Law is designed to encourage the spending and consumption which accompanies residency and employment, and which contributes to West Berlin's economic vitality. The payments made pursuant to the Berlin Promotion Law were made in anticipation of such economic benefits; therefore, the payments were not gifts but are includable in petitioner's income pursuant to section 61.

We are aware that payments made by the United States pursuant to certain social benefit programs as relief from poverty, unemployment, sickness, aging or lack of education, may be excluded, at least in part, from income. The payments received by petitioner were not predicated on need nor were they made in furtherance of a social program sponsored by the United States. On the contrary, petitioner was eligible for the payments because he was a wage earner; the payments were intended to benefit only the economy of West Berlin. Petitioner's comparison of the Berlin Promotion Law to U.S. social benefit programs is inapposite.

To reflect the foregoing,

Decision will be entered under Rule 155.

MARK G. SCHAD, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 26148-84, 28216-84. Filed September 17, 1986.

Held, petitioner is liable as transferee of $800,000 given to him in December 1977 by an individual who was later killed; the transfer was a gift causa mortis which rendered the donor insolvent. *Held, further*, petitioner failed to carry his burden of showing that $174,679 forfeited to the State and

$14,200 used to purchase real estate in 1983 were not derived from taxable income. *Held, further,* petitioner failed to prove that he is not liable for additions to tax under secs. 6651(a), 6653(a)(1) and (2), and 6654, I.R.C. 1954, for 1983.

Thomas G. Christmann and *Walter M. Tovkach*, for the petitioner.

Francis C. Mucciolo, for the respondent.

FEATHERSTON, *Judge*: Respondent determined in docket No. 28216-84 that petitioner is liable to the extent of $300,000 as transferee of Joseph F. Collins, deceased. Respondent also determined in docket No. 26148-84 a deficiency in the amount of $93,779 in petitioner's 1983 income tax together with additions to tax in the amount of $9,193 under section 6651(a)(1),[1] $4,689 under section 6653(a)(1), $5,521 under section 6654, and 50 percent of the interest due on $93,779 under section 6653(a)(2). The issues presented for decision are as follows:

(1) Whether petitioner is liable as a transferee of the assets of Joseph F. Collins, deceased;

(2) Whether $174,679 seized from petitioner by agents of the Florida Department of Law Enforcement in November 1983 during his attempt to purchase 600 pounds of marijuana and $14,200 used by him to purchase certain real estate are taxable to him as income for 1983; and

(3) Whether petitioner is liable for additions to tax under sections 6651(a)(1), 6653(a)(1), 6653(a)(2), and 6654 for 1983.

FINDINGS OF FACT

Petitioner was a legal resident of Ocala, Florida, when he filed the petitions in these cases. He filed his income tax return for 1983 with the Internal Revenue Service Center, Atlanta, Georgia, on January 25, 1985.

1. *Transferee Liability Issue*

Petitioner met Joseph F. Collins (Collins) in the Florida Keys in the fall of 1973 when petitioner was 19 and Collins was 21 years of age. During 1977, petitioner worked for

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[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted.

Collins in a boat repair business, and they were close personal friends.

In January 1977, Collins was convicted in the U.S. District Court for the Southern District of Mississippi on charges of conspiring to import, distribute, and possess marijuana. In December 1977, petitioner received $300,000 from Collins; Collins told petitioner at that time that if anything happened to him (Collins), the money would become petitioner's. Collins was afraid to keep the money at his own house; he was fearful that certain individuals who had attempted to kill him a short time previously would try again if he kept the money.

On May 4, 1978, Collins died from gunshot wounds received in a gun battle in Key West, Florida, in which Collins was armed with a Thompson machine gun. During the month of May 1978, intestacy proceedings were instituted for the probate of Collins' estate in Monroe County, Florida. The value of his estate, without taking into consideration the $300,000 transferred to petitioner and any tax liabilities of the estate, was $7,842.21 as of August 26, 1978. The personal representatives of Collins' estate paid creditors $191.50 on claims against the estate and attorney fees of $658 in October 1978 and distributed the remainder to his parents. Petitioner did not turn over to the personal representatives of Collins' estate or to Collins' parents any of the money he received from Collins in December 1977.

In 1984, respondent determined that Collins received income of $300,000 for 1977 which he failed to report and, as a result, owed an income tax deficiency and additions to tax and interest as of May 17, 1984, in the total amount of $421,801.42. There is no evidence in the record challenging the correctness of this determination.

Taking into account Collins' liability for 1977 income tax deficiencies, additions to tax, and interest, Collins' transfer of the $300,000 to petitioner was made when Collins was insolvent or it rendered Collins and his estate insolvent. For respondent to have attempted to collect those liabilities from Collins' estate would have been a useless gesture. Respondent determined that petitioner is liable as transferee to the extent of $300,000 of Collins' unpaid taxes, additions to tax, and interest for 1977.

2. *Income Tax Deficiency Issue*

The income tax returns filed by petitioner for 1981, 198 and 1983 state that he was a self-employed carpenter. T Schedules C attached to those returns show that his gro receipts ranged from $13,917 to $17,125 and that his n profit was approximately $14,000 per year. The schedul show no expenditures for cost of goods sold in any ye except expenditures of $4,147.70 for such purpose for 198

In 1979, petitioner paid cash of $62,500 for some re property in Broward County, Florida. In 1980, he pai approximately $10,000 toward the purchase of a mobi home located in Ocala. In 1981, he paid cash of $6,000 for 1980 Pontiac automobile. In the summer of 1983, he bough a 1982 pickup truck for cash of $10,000. In 1983, he als loaned $2,500 to one of his sisters and $1,400 to anothe sister.

In June 1978, petitioner attempted to transport 3 pounds of marijuana from Miami to Minnesota and wa arrested at the Miami Airport. In 1981, he was stopped fo speeding and the officer found some marijuana in his vehicl and arrested him on a misdemeanor charge. Petitioner wa not convicted of a crime as a result of these arrests.

On November 4, 1983, petitioner received a telephone cal from Robert A. Anslow (Anslow), whom he had known for 3 or 4 years, inviting him to come to Tallahassee and bring with him as much cash as he had available for investment in a business venture. Petitioner took $174,679 to Tallahassee. Anslow told petitioner that he wanted petitioner to buy 600 pounds of marijuana which had been offered for sale at a price of $320 to $330 per pound. Other individuals who had met Anslow and petitioner in Tallahassee were to assist in marketing the purchase.

Petitioner examined a sample of the marijuana and concluded that the price was too high and the quality was not satisfactory. Petitioner later went to inspect the remainder of the marijuana and was arrested by the purported sellers, who turned out to be agents of the Florida Department of Law Enforcement.

Petitioner's attempted purchase of the 600 pounds of marijuana was part of a larger transaction involving several hundred more pounds of marijuana. Seven other individuals, in addition to petitioner, were arrested in connection with the activity and six of them, including Anslow, pleaded guilty to violating portions of title 21 of the United States Code. Petitioner and petitioner's brother were indicted on a charge of conspiring to possess with intent to distribute marijuana in violation of sections 841 and 846 of title 21 of the United States Code. Petitioner was found not guilty by a jury and a directed judgment of acquittal was entered in the case of petitioner's brother.

In the course of the arrest of petitioner and others on or about November 5, 1983, Florida Department of Law Enforcement agents and other local law enforcement agents seized property that was in the possession of the individuals who were arrested. They seized approximately $174,000 in currency from petitioner. Forfeiture proceedings were instituted in the State court and none of the currency was returned to petitioner.

In the notice of deficiency issued to petitioner for 1983, respondent used the expenditures method of income reconstruction and determined that petitioner had taxable income of $200,879, consisting of the following:

Real estate purchase in Marion County..........	$14,200
Cash seized by State law enforcement officers ...	174,679
Personal living expenses at $1,000 per month....	12,000
Total known expenditures......................	200,879

On this basis, respondent determined the deficiency and additions to tax here in dispute.

OPINION

1. *Transferee Liability*

Section 6901(a)(1)(A) authorizes the assessment of transferee liability, at law or in equity, in the same manner as the liability for income taxes. This provision, however, does not create any separate liability; it merely provides a secondary method for enforcing the existing liability of a transferor. *Mysse v. Commissioner*, 57 T.C. 680, 700-701 (1972); *C.B.C. Super Markets, Inc. v. Commissioner*, 54 T.C. 882, 897-898 (1970). The substantive question of whether a transferee is liable for his transferor's obligation and the extent of his liability depends upon State law. See, e.g., *Commissioner v. Stern*, 357 U.S. 39, 45 (1958); *United States v. Fernon*, 640 F.2d 609, 611 (5th Cir. 1981).

To support his determination that petitioner is liable as transferee for the taxes owed by Collins, respondent relies upon Florida Statutes Annotated section 726.01 (West 1969) which provides, in pertinent part, that every gift or transfer of goods made with the purpose or intent to delay, hinder, or defraud creditors shall be void and of no effect. To constitute a fraudulent conveyance under this section "there must be a creditor to be defrauded, a debtor intending fraud, and a conveyance of property which is applicable by law to the payment of the debt due." *Bay View Estates Corp. v. Southerland*, 114 Fla. 635, 154 So. 894, 900 (1934). Obviously, the Government was a creditor of Collins for the taxes he owed and, because he transferred the $300,000 to petitioner without consideration, that sum was subject to application on his tax debt. The intention to defraud in this context consists of an intentional act of withdrawing property from the reach of creditors. *Bay View Estates Corp. v. Southerland*, 154 So. at 900. A conveyance without consideration by one who is indebted and insolvent is presumptively fraudulent, regardless of the actual intent of the transferor, when attacked by an existing creditor. *United States v. Ressler*, 433 F. Supp. 459, 464 (S.D. Fla. 1977); *Ostend Realty Co. v. Biscayne Realty & Ins. Co.*, 99 Fla. 1221, 128 So. 643, 645 (1930).

Apart from the presumption arising from a gratuitous transfer by an insolvent debtor, the requisite intention to defraud can be found or inferred from indicia of fraud such as:

> (1) lack of consideration for the transfer, *Gyorok v. Davis*, 183 So. 2d 701, 703 (Fla. App. 1966); (2) close family relationship between the transferor and the transferee, *Fisher v. Grady*, 131 Fla. 1, 14, 178 So. 852, 858 (1937); (3) pending or threatened litigation against the transferor, *Money v. Powell*, 139 So. 2d 702, 704 (Fla. App. 1962); and (4) insolvency or substantial indebtedness of the transferor, *Banner Construction Corp. v. Arnold*, 128 So. 2d 893, 896 (Fla. App. 1961). * * * [*United States v. Fernon*, 640 F.2d at 613.]

At Collins' death in May 1978, he owed the Government income taxes, additions to tax, and interest for 1977 in an amount in excess of $400,000. Even though those liabilities were unassessed at the time, they must be taken into account as a debt in determining Collins' solvency and petitioner's liability as Collins' transferee. *Kreps v. Commissioner*, 351 F.2d 1, 10 (2d Cir. 1965), affg. 42 T.C. 660 (1964); *Scott v. Commissioner*, 117 F.2d 36, 38 (8th Cir. 1941), affg. a Memorandum Opinion of this Court. Because Collins had assets of only $7,842.21 at his death, the $300,000 gratuitous transfer to petitioner rendered Collins and, later, his estate insolvent. See *Banner Construction Corp. v. Arnold*, 128 So. 2d 893, 896 (Fla. App. 1961). Although petitioner was not a blood relative of Collins, he was employed by Collins during 1977 and was a close associate and trusted friend. See *Money v. Powell*, 139 So. 2d 702, 704 (Fla. App. 1962). As a result of Collins' transfer of the money to petitioner, the money was placed beyond the reach of Collins' creditors except through transferee proceedings. We hold that the transfer was a fraudulent transfer under Florida law and that petitioner is liable as Collins' transferee of these funds.

Petitioner contends that he is not a transferee of the $300,000 because Collins did not "transfer" it to him. He argues that Collins did not make a gift to him in December 1977 because "a condition was placed on the arrangement, i.e., Collins had to die before the money became Petitioner's." Further, he argues, petitioner did not inherit the money under Florida law because Fla. Stat. Ann. section 732.502 (West 1976) expressly provides that every will must be in writing and signed and witnessed in a prescribed manner. Any will that does not comply with the statute is not effective. *In re Neil's Estate*, 39 So. 2d 801 (Fla. 1949). Accordingly, the argument goes, it is irrelevant under Florida law that petitioner mistakenly believed the money to be his and treated it as if it were his own after Collins' death.

Petitioner's argument misconceives the legal effect of the delivery of the money to him. As we understand Florida law, Collins' transfer to petitioner was a gift causa mortis. Such a gift has some of the characteristics of a gift inter vivos and some of a testamentary disposition and falls between those two concepts.

In *Leonard v. Campbell*, 138 Fla. 405, 189 So. 839, 840 (1939), the court explained that to constitute a gift causa mortis—

> there must be an intention to give, a delivery so that the donor loses dominion over the gift and donee retains possession until donor's death, and a contemplation of death from present illness or impending danger. * * * It is revocable at the will of the donor; by his survival of the danger; by his outliving the donee; or by deficiency of assets to pay debts of a deceased donor. In this feature of defeasibility it is distinguishable from a gift inter vivos. * * *

A similar definition appears in *Szabo v. Speckman*, 73 Fla. 374, 74 So. 411, 413 (1917).[2] See also *Wright v. Brown*, 146 Fla. 572, 1 So. 2d 871 (1941); *Heyser v. Crane*, 144 Fla. 663, 198 So. 472 (1940). We have found no Florida cases dealing directly with the issue, but the general rule is that a gift causa mortis is not invalid because it is not in writing and executed in the form essential to a will. *In re Nols' Estate*, 251 Wis. 90, 28 N.W.2d 360, 363 (1947); *Cannon v. Williams*, 194 Ga. 808, 22 S.E.2d 838, 845-846 (1942); *Johnson v. Colley*, 101 Va. 414, 44 S.E. 721, 722-723 (1903). 1 W. Page, Wills, sec. 6.1, at 220 (1960); T. Atkinson, Handbook of the Law of Wills 205-206 (1953).

In the instant case, the facts show a gift causa mortis. Shortly before Collins turned the $300,000 over to petitioner in December 1977, certain individuals had tried to kill Collins and he expected them to try again. He believed he faced a very real impending danger. Collins delivered the $300,000 to petitioner and told him that if anything happened to Collins, the money belonged to petitioner. The implication is that petitioner was to return the money to Collins if he requested it or if he survived the danger he then faced. A short time later Collins was killed, and petitioner kept the money and treated it as his own. When asked whose money it was at Collins' death, petitioner responded: "In my mind, it was mine." Because Collins was insolvent at the time of, or was rendered insolvent by, the transfer of the funds, petitioner is liable to the Government as transferee.

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[2] In *Szabo v. Speckman*, 73 Fla. 374, 74 So. 411, 413 (1917), the court said:

"A gift of this character must be made in contemplation of the near approach of death from danger then impending, to take effect absolutely only upon the death of the donor. There must be delivery to the donee, actual or constructive, of the thing given, or the means of getting possession and enjoyment of it. 'It is the fact of delivery that converts the unexecuted purpose into an executed and complete gift.' "

Petitioner argues that he cannot, in any event, be held liable as transferee of the full $300,000 because $174,679 of it was forfeited to the State of Florida when he was arrested in November 1983. As we shall discuss, we are not convinced that the forfeited money was part of the money received from Collins. Even if it was, however, petitioner kept the money, admittedly used much of it, and regarded it as his own. He used the $174,679 in such manner as to subject it to forfeiture. Had he lost the money by gambling or making a bad investment, for example, he could not now be heard to deny liability on the ground he does not have the dollars he received from Collins. Similarly, his use of the $174,679 in such manner as to expose it to forfeiture to the State does not provide a defense to transferee liability to Collins' creditor, the Federal Government.

2. *The Deficiency Issue*

The deficiency for 1983 was determined by use of the cash expenditures method of income reconstruction and was based on three income items, cash in the amount of $14,200 used to purchase real estate in Marion County, cash in the amount of $174,679 seized by State law enforcement officials, and estimated personal living expenses in the amount of $12,000. Petitioner contends, and respondent denies, that the cash involved in the first two items was part of the $300,000 Collins placed in petitioner's custody in December 1977. As to the living expenses, petitioner's 1983 income tax return, filed January 25, 1983, shows adjusted gross income of approximately $12,500; petitioner offered no evidence to show that the $12,000 estimate was erroneous, and we, therefore, treat that item as resolved.

Petitioner contends that, when Collins gave him the $300,000 in a suitcase, he placed the suitcase in the crawl space under his house in North Miami and kept it there. When he moved to Ocala, he maintains that he put a floor safe under the doghouse in his yard and kept the money there. When he paid $14,200 for real estate in Marion County in 1983, he testified that he used the Collins money to make the payment. When Anslow called him and invited him to bring all the money he had to invest in a "business venture," he contends that he took the $174,679 of Collins' money to Tallahassee where it was seized by and forfeited to the State law enforcement officials. Under this version of the facts, petitioner argues that he had no unreported income for 1983 and the determined deficiency was erroneous.

The crucial factual issue to be resolved is whether the money used to buy the Marion County land and the money forfeited to the State came from a 1983 income generating activity or from the nontaxable Collins gift. Citing *Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979), revg. 67 T.C. 672 (1977), petitioner argues that respondent has the burden of proving that the forfeited $174,679 was income generated in 1983 from drug dealing and that respondent has not carried that burden.

In the usual case, petitioner would have the burden of proof as to both items of income. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. In *Weimerskirch v. Commissioner*, *supra*, the Commissioner determined that the taxpayer had a deficiency in his income tax based on a revenue agent's finding that the taxpayer omitted income derived from heroin sales. The only evidence supporting this determination were statements made to the agent by two confidential informants and certain information obtained by him from law enforcement officials. No admissible evidence was introduced at the trial to substantiate those statements or information or otherwise linking the taxpayer to drug dealing. The Court of Appeals held that a "deficiency determination which is not supported by the proper foundation of substantive evidence is clearly arbitrary and erroneous" and that the Government had the burden of producing some evidence linking the taxpayer to an income-producing activity. 596 F.2d at 362. See also *United States v. Janis*, 428 U.S. 433 (1976); *Llorente v. Commissioner*, 649 F.2d 152 (2d Cir. 1981), affg. in part and revg. and remanding in part on this issue 74 T.C. 260 (1980); *Jackson v. Commissioner*, 73 T.C. 394 (1979).

The crucial distinction between the *Weimerskirch* line of cases, on the one hand, and the instant one, on the other, is that petitioner had in his possession on November 4, 1983, cash in the amount of $174,679 which he brought to Tallahassee and attempted to use in the purchase of marijuana. Petitioner's only explanation of his possession of this large sum of money was his assertion that it was Collins' money taken from his doghouse safe, and the credibility of that explanation is at issue. In the *Weimerskirch* line of cases, the taxpayers were not shown by admissible evidence to have actually possessed any of the funds that the Commissioner determined to be taxable income.

The distinction was explained by the Court of Appeals that decided *Weimerskirch* in a subsequent case, *Delaney v. Commissioner*, 743 F.2d 670 (9th Cir. 1984), affg. a Memorandum Opinion of this Court, where the Commissioner determined that $43,000 in Swiss gold coins and $305 in unexplained bank deposits were unreported income. The court stated (*Delaney v. Commissioner*, *supra* at 671-672):

> The Delaneys concede as true the IRS's evidence that the Delaneys brought into the country over $40,000 in gold coins over a two-year period. In the course of an IRS audit of their tax returns, the Delaneys gave what the IRS deemed incomplete or unsatisfactory answers to inquiries concerning the acquisition of the gold. The presumption of correctness applies in these circumstances. *Calhoun v. United States*, 591 F.2d 1243, 1245 (9th Cir. 1978), cert. denied, 439 U.S. 1118, 99 S.Ct. 1025, 59 L.Ed.2d 77 (1979); *Ruark v. Commissioner*, 449 F.2d 311, 312 (9th Cir. 1971) (per curiam).
>
> The Government correctly distinguishes *Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979), as a case in which the Commissioner failed to connect the taxpayer to the alleged assets that were the basis of the deficiency. By contrast, the Delaneys are the admitted owners of the asset that is the basis of the deficiency. *Weimerskirch* is thus inapplicable.

See also, e.g., *Boyett v. Commissioner*, 204 F.2d 205, 208 (5th Cir. 1953), affg. a Memorandum Opinion of this Court; *Estate of Mason v. Commissioner*, 64 T.C. 651, 656 (1975), affd. 566 F.2d 2 (6th Cir. 1977), and the long list of cases there cited; cf. *Tokarski v. Commissioner*, 87 T.C. 74 (1986). We do not think the *Weimerskirch* line of cases was intended to exempt narcotics dealers from these long-established legal principles and create a safe haven for them, permitting them to be taxed on money in their possession only if they are caught in the act of buying or selling narcotics for a profit. We think connecting petitioner to the funds that form the basis of the deficiency is sufficient to give him the burden of proving the deficiency determination erroneous.

We must then decide the credibility of petitioner's explanation that the $174,679 was part of the money Collins gave him in 1977, 6 years previously. Positive and uncontradicted testimony of a particular fact will ordinarily be accepted, but testimony which is inherently questionable, improbable, or unreasonable may be rejected even though no contradictory testimony is offered. *Boyett v. Commissioner*, 204 F.2d 205, 208 (5th Cir. 1953), affg. a Memorandum Opinion of this Court.

Petitioner testified, as we have stated, that he kept the Collins money he received in 1977 in the crawl space under his home in North Miami and later in Ocala in a floor safe under his doghouse. He testified in his deposition in the proceedings for the forfeiture of these funds that Robert and Becky Clift, Danny and Darryl Cunningham, petitioner's father-in-law, Lloyd Athey, and petitioner's wife knew about his Collins money, but he called none of those individuals to corroborate in any way the fact or the amount of the Collins money remaining in 1983. *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947). He rested his entire case on his own self-serving uncorroborated assertions.

Petitioner introduced in evidence no records of any kind and no other accounting for the use of the $300,000 over the 6-year period that he contends he held it.[3] On direct

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[3] In *Webb v. Commissioner*, 394 F.2d 366, 373 (5th Cir. 1968), affg. a Memorandum Opinion of this Court, the court said:

"the absence of adequate tax records does not give the Commissioner carte blanche for imposing Draconian absolutes.[,] * * * [However,] such absence does weaken any critique of the Commissioner's methodology. * * *

"Arithmetic precision was originally and exclusively in [the taxpayer's] hands, and he had a statutory duty to provide it. * * * Having defaulted in his duty, he cannot frustrate the Commissioner's reasonable attempts by compelling investigation and recomputation under every means of income determination. Nor should he be overly chagrined at the Tax Court's reluctance to credit every word of his negative wails. * * *"

See also *Adamson v. Commissioner*, 745 F.2d 541, 548 (9th Cir. 1984), affg. a Memorandum Opinion of this Court; *Keogh v. Commissioner*, 713 F.2d 496, 502 (9th Cir. 1983), affg. a examination, he limited his testimony to a conclusory statement that the $174,679 was the same money he received from Collins. On cross-examination, he admitted that he had used at least $100,000 of the Collins money to buy real estate and automobiles and to make loans to his sisters. But he limited his admissions almost exclusively to transactions respondent was able to document. He also testified that he used some of the Collins money to buy building materials for his carpentry business but did not know how much.

According to petitioner's testimony on cross-examination, in both 1979 and 1980, before he was licensed for home construction, he built between 6 and 10 additions to houses and on each addition spent $1,000 to $1,500 for materials. Beginning in 1980, after he was licensed, he constructed house additions at the rate of "a dozen or so" a year and in the fall of 1983 he started the construction of a house. In fact, he testified that he had placed $9,000 to $10,000 of the money seized by the Florida police in a separate briefcase for his use in the purchase of building materials. According to his testimony, all or a part of the costs of these materials was paid from Collins' money which he replaced in whole or in part when he was paid for his services. Yet as noted above, his 1981 and 1982 income tax returns show no expenditures for cost of materials and his 1983 return shows an expenditure of only $4,147.70 for materials in that year. This inconsistency is not explained.

Petitioner's explanation for not banking the Collins' money was fear that the people who killed Collins would try to kill him. But he would have us believe that he used Collins' currency in carrying out all of these substantial business transactions apparently without trepidation. The use of currency in such large quantities for the purchase of real estate and building materials, if we are to believe his testimony in this respect, would inevitably raise questions and attract attention. Moreover, there is no explanation of why he did not bank his construction business receipts rather than return them to his doghouse safe. This whole line of testimony raises serious doubts as to credibility. We

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Memorandum Opinion of this Court; *United States v. Stonehill*, 702 F.2d 1288, 1296 (9th Cir. 1983).

are not convinced that the reported construction busine was not a front for other activities.

In a deposition taken on May 16, 1984, in the State cou proceedings for the forfeiture of the $174,679, petition was questioned in great detail on how he acquired t money and what he did with it after Collins gave it to hi At one point in the deposition, on being asked whether t cash he had when he was arrested "was the exa same * * * bills you had received" from Collins, he repli that "some of it was and some of it wasn't." He testifi that he had earned some of the money and added it to t Collins cache and that he could not "honestly tell you" ho much of it was Collins money. Yet, at the trial of t instant case he testified that "it was all Joe's money Again, these inconsistencies raise serious doubts as petitioner's credibility.

Further, his whole account of the circumstances in whi he took the $174,679 to Tallahassee in response to telephone call from Anslow in November 1983 is incredi for one who had carefully safeguarded a large sum of mon for 6 years. For all of those years since Collins' deat petitioner testified he had been afraid to deposit the Colli money in a bank lest the men who killed Collins would k him. According to his testimony, he did not know wh Anslow did for a living and saw him only 2 or 3 times year during the 3 or 4 years that he had known him. Ye according to his testimony, when Anslow called him an asked him to put together whatever funds he could an come to Tallahassee for a business venture, he took t $174,679 out of his doghouse safe and responded to th casual friend's invitation without asking for any explanati of the proposed transaction.

Petitioner did not learn that he was to buy marijuana, t story goes, until he met Anslow in Tallahassee. Althou petitioner denied he had ever before bought a controll substance, he did not flinch when he learned what Anslo proposed. Rather, he engineered all further activity an took full responsibility for determining the quality and t reasonableness of the price of the marijuana that was f sale. If his denials of any previous involvement in marijua purchases and sales are true, we think it incredible that h a neophyte in the narcotics world, would have taken over from Anslow and his other confederates the engineering of the negotiations for the purchase of 600 pounds of marijuana at a cost of some $175,000.

Viewing the record as a whole, we are not convinced that the $174,679 was not money petitioner had made in 1983 from narcotics dealings. Petitioner has a long history of marijuana activity. Collins, a long-time friend, who gave petitioner the $300,000 in December 1977, had been convicted on a marijuana charge earlier that year. In 1978, petitioner was arrested for attempting to transport 30 pounds of marijuana from Miami to Minnesota. In 1981, he was caught with marijuana in his truck. Then, in November 1983, he took the $174,679 to Tallahassee and actively participated in the abortive attempt to purchase 600 pounds of marijuana. True, he was not convicted as a result of any of those activities but he admitted that they occurred. Given this background, the absence of any corroborating records or testimony, and the evasiveness and inconsistencies in his accounts of the source of the $174,679, we find that petitioner has not carried his burden of proof.

We are aware that the results of this conclusion would be Draconian, indeed, if the $174,679 was part of the Collins money. Petitioner would be subjected to transferee liability, taxation, and forfeiture[4] for the same amount. We have been very conscious of this consideration in weighing the evidence. As we view the credible evidence, however, it will simply not support a finding that the $174,679 forfeited to the State or the $14,200 used to buy the Marion County real estate was part of the Collins money or that it was not income earned in 1983.

3. *Additions to Tax Issue*

Apart from his contentions that he is not liable as transferee and that the $174,679 was not taxable income, petitioner offered no evidence to show that he is not liable for the determined additions to tax. Consistent with our holdings on the transferee and deficiency issues, respondent's determinations as to the additions to tax are sustained.

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[4] The law is settled that a deduction is not allowable for property forfeited in connection with illegal marijuana and other narcotics dealing activity. E.g., *Holmes Enterprises, Inc. v. Commissioner*, 69 T.C. 114, 116-117 (1977); *Holt v. Commissioner*, 69 T.C. 75, 79 (1977), affd. per curiam 611 F.2d 1160 (5th Cir. 1980).

To reflect the foregoing,

Decisions will be entered for the respondent.

HONEYWELL INC. AND SUBSIDIARIES, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 15807-83. Filed September 22, 1986.

P manufactured, leased, and sold computers and reported depreciation under the Class Life Asset Depreciation Range system described in sec. 1.167(a)-11(d)(3), Income Tax Regs. Literally applying the regulations, P reported sales of leased computers as credits to its depreciation reserve until the appropriate vintage account balance was exceeded, thereby delaying realization of income from sales. R determined that computers held for sale and/or lease were "dual purpose property" not covered by his regulations. *Held*, P correctly reported income from sales of computers.

P's subsidiary issued debentures convertible into stock of P. *Held*:

1. P cannot amortize as original issue discount a portion of the issue price attributable to the conversion privilege.

2. P cannot amortize as bond premium the difference between the fair market value of the stock issued on conversion and the face value of the debentures. *National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982), followed.

Clinton A. Schroeder, *David C. Bahls*, and *Myron L. Frans*, for the petitioner.

James F. Kidd, for the respondent.

OPINION

COHEN, *Judge*: Respondent determined deficiencies of $1,592,852 and $9,542,483 in petitioner's Federal income taxes for 1976 and 1977, respectively. Certain of the adjustments in the statutory notice of deficiency have been resolved by agreement, and all of the facts have been stipulated. Three issues remain to be resolved on cross motions for partial summary judgment. They are:

(1) Whether sales of leased equipment depreciated under the Class Life Asset Depreciation Range (CLADR) system constitute ordinary retirements under section 1.167(a)-11(d)(3), Income Tax Regs.;

(2) Whether amortizable original issue discount arises on the issuance of debentures by a subsidiary, convertible into stock of its parent, to the extent that the issue price is attributable to the conversion privilege; and

(3) Whether amortizable bond premium arises upon conversion of debentures, equal to the difference between the fair market value of stock distributed in exchange for the debentures and the face value of the debentures.

Honeywell Inc. (petitioner) is a Delaware corporation with its corporate headquarters in Minneapolis, Minnesota. Petitioner and its numerous domestic and foreign subsidiaries engage on a worldwide basis in the design, manufacture, sale, and service of automation equipment and systems, including automation systems and controls for homes and buildings, industrial controls and control systems, aerospace and defense systems, and computer and communication products.

Petitioner and its domestic subsidiaries file consolidated Federal income tax returns using the accrual method of accounting with the calendar year as the taxable year. Petitioner timely filed its Federal income tax returns for 1976 and 1977 with the Internal Revenue Service Center at Ogden, Utah. In addition to disputing the amounts determined by respondent in the statutory notice, petitioner contends that it overpaid its Federal income taxes by $415,509 and $361,591 for 1976 and 1977, respectively.

Sales of Leased Computers

Since 1957, petitioner has developed and manufactured electronic data processing (EDP) systems. An EDP system, often termed and hereinafter referred to as a computer, is a complex series of equipment consisting of a central processor, input devices, and output devices. Input devices are mechanisms for reading data off punched cards, magnetic tape, and other similar input media, and translating it into a form usable by a central processor. Output devices are mechanisms such as printers and magnetic tape units which transcribe data from the central processor into a form that can be used or stored outside the central processor.

Since 1970, petitioner's computer business has been conducted principally by its subsidiary, Honeywell Information Systems Inc. (HIS). For purposes of this action there is no need to differentiate between petitioner and HIS, so reference generally will be made simply to petitioner with the understanding that the activities described are in most instances carried on by HIS.

As petitioner's computer business evolved, it came to include both outright sales of new computers to customers, leases of computers to lessees, and sales of leased computers to lessees. Petitioner now manufactures, sells, and leases computers.

The computer business is capital intensive, requires vast expenditures for research and development, and changes rapidly, with equipment quickly becoming technologically obsolete. This means, on the one hand, that manufacturers are particularly concerned with maximizing the number of units delivered to customers and, on the other hand, that customers are frequently reluctant to purchase computers outright. Leasing is a way to accommodate both sets of concerns and, consequently, the leasing of computers has become a significant economic activity.

A willingness to lease computers is a vital part of the business of computer manufacturers such as petitioner. Many potential customers either cannot afford to purchase the equipment or prefer to lease the equipment for financial, tax, or accounting reasons. From the manufacturer's point of view, the ability to lease computers enables it to reach more customers, which permits the generation of additional revenue to offset the massive overhead involved in the development and manufacture of computers. In the computer industry, leasing is so important that a failure to offer leasing as an option would seriously circumscribe a manufacturer's business by substantially reducing the volume of computers that it could ship to customers, thereby reducing its potential revenue and making it more difficult to operate profitably.

The computer business is a significant part of petitioner's business. Petitioner's revenue from its computer business in 1976 and 1977 was approximately 36 percent of its total revenues. More than 30 percent of total inventories as of December 31, 1977, related to its computer business. As of December 31, 1977, more than 70 percent of petitioner's investment in tangible property (land, buildings and improvements, machinery and equipment, and construction in progress), net of accumulated depreciation, was invested in property used in its computer business. During the years in issue, petitioner's investment in equipment leased by it to third parties was in excess of 60 percent of its total investment in tangible property, whether measured by cost or net book value.

Petitioner's revenues from computer rental and service were as follows in 1976 and 1977, which were typical of other years:

	1976	*1977*
Computer rental revenue	$304,000,000	$323,000,000
Computer service revenue	218,000,000	275,000,000
Total	522,000,000	598,000,000
Percentage of information systems (computer business) revenue	57.1%	57.7%
Percentage of total revenue	20.9	20.5

The computer service category includes maintenance service income on computers that have been leased as well as sold.

Petitioner must supply the capital to finance its costs of owning leased computers either through retention of earnings, issuance of stock, or borrowing. Petitioner borrows substantial amounts of capital in order to finance its computer business in general, and its ownership of leased computers, in particular.

All leases of computers by petitioner were subject to written lease contracts. Various forms of contracts were used from time to time, depending upon the length of the lease and other factors, and the forms in use were changed from time to time. Such contracts generally granted the lessee an option to purchase the leased equipment and provided that a portion of the rentals paid would be credited against the sales price upon the exercise of the option.

Some of the computers initially leased to customers in 1976 ultimately were sold in 1976. The total sales proceeds from the sale of such computers were $4,978,492. Some of the computers initially leased to customers in either 1976 or 1977 ultimately were sold in 1977. The total sales proceeds from the sales of such computers were $26,002,110.

Petitioner's cost of new computers originally placed in service by lease in each of the years 1976 through 1980, and the percentage, by cost, of those leased computers which were sold in each of the years 1976 through 1983 are as shown on page 629.

No lessee was under any obligation to purchase the equipment being leased. If a lessee decided to consider purchasing the equipment, that was a voluntary choice on the lessee's part over which petitioner did not exercise control.

Petitioner was engaged in the trade or business of leasing computers and of selling computers within the meaning of the Internal Revenue Code at all times relevant to this action. For all times material and up to the time that the equipment was sold, respondent has allowed petitioner to treat the computers manufactured by it and leased to its customers as section 1245[1] property for which a depreciation deduction was allowable and as section 1231 property by reason of being used in petitioner's trade or business as soon as they were held for the time required by section 1231(b)(1).

Petitioner elected to depreciate all of its computers that it placed in service by leasing to customers in 1976 and 1977 under the CLADR system pursuant to section 167(m) and section 1.167(a)-11, Income Tax Regs., which provides in pertinent part as follows:

> (a) *In general*—(1) *Summary*. This section provides an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years here in issue.

Year placed in service	*1976*	*1977*	*1978*	*1979*	*1980*
Cost of computers placed on lease during the year	$127,784,092	$110,978,436	$120,875,786	$131,715,222	$129,113,569
Percentage of cost of computers placed on lease during the year, subsequently sold in—					
1976	1.9%	...	...	...	...
1977	3.4	5.7%	...	...	...
1978	3.8	4.9	1.2%	...	...
1979	4.3	4.8	12.2	3.4%	...
1980	3.3	4.6	4.4	5.7	1.9%
1981	4.4	4.9	5.8	6.4	5.9
1982	2.6	4.0	4.0	5.4	5.1
1983	2.9	4.0	4.4	4.2	5.0
Total percentage by cost of computers initially leased and subsequently sold	26.6	32.9	32.0	25.1	17.9

property, and as to salvage value, repairs, and other matters. The system is optional with the taxpayer. The taxpayer has an annual election. * * * Generally, the taxpayer must establish vintage accounts for all eligible property included in the election, must determine the allowance for depreciation of such property in the taxable year of election, and in subsequent taxable years, on the basis of the asset depreciation period specified in the election, and must apply the first-year convention specified in the election to determine the allowance for depreciation of such property. This section also contains special provisions for the treatment of salvage value, retirements, and the costs of the repair, maintenance, rehabilitation or improvement of property. In general, a taxpayer may not apply any provision of this section unless he makes an election and thereby consents to, and agrees to apply, all the provisions of this section. A taxpayer who elects to apply this section does, however, have certain options as to the application of specified provisions of this section. A taxpayer may elect to apply this section for a taxable year only if for such taxable year he complies with the reporting requirements of paragraph (f)(4) of this section.

(2) *Definitions*. For the meaning of certain terms used in this section, see paragraphs * * * (d)(3)(ii) ("ordinary retirement" and "extraordinary retirement") * * *

(b) *Reasonable allowance using asset depreciation ranges*— * * *

* * * * * * *

(3) *Requirement of vintage accounts*—(i) *In general*. For purposes of this section, a "vintage account" is a closed-end depreciation account containing eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election. The "vintage" of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. * * *

* * * * * * *

(d) *Special rules for salvage, repairs and retirements*— * * *

* * * * * * *

(3) *Treatment of retirements*—(i) *In general*. The rules of this subparagraph specify the treatment of all retirements from vintage accounts. * * * An asset in a vintage account is retired when such asset is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment of an asset. A retirement may also occur by transfer of an asset to supplies or scrap.

(ii) *Definitions of ordinary and extraordinary retirements*. The term "ordinary retirement" means any retirement of section 1245 property from a vintage account which is not treated as an "extraordinary retirement" under this subparagraph. * * *

> (iii) *Treatment of ordinary retirements.* No loss shall be recognized upon an ordinary retirement. Gain shall be recognized only to the extent specified in this subparagraph. All proceeds from ordinary retirements shall be added to the depreciation reserve of the vintage account from which the retirement occurs. See subdivision (vi) of this subparagraph fcr optional allocation of basis in the case of a special basis vintage account. See subdivision (ix) of this subparagraph for recognition of gain when the depreciation reserve exceeds the unadjusted basis of the vintage account. * * *
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> * * * * * * *
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> (ix) *Recognition of gain or loss in certain situations.* (*a*) In the case of a vintage account for section 1245 property, if at the end of any taxable year after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section, the depreciation reserve established for such account exceeds the unadjusted basis of the account, the entire amount of such excess shall be recognized as gain in such taxable year. * * *

The parties agree that the subject sales are not extraordinary retirements.

Petitioner established vintage accounts for the computers leased during 1976 and 1977, respectively; established a depreciation reserve for each vintage account; and properly depreciated the computers in accordance with its CLADR election in 1976 and 1977 prior to their sale.

In accordance with its view of section 1.167(a)-11, Income Tax Regs., petitioner did not recognize gain on the sale of the computers initially leased during 1976 and subsequently sold during 1976 or 1977 or on the sale of the computers initially leased during 1977 and subsequently sold in 1977. The proceeds from the sales of such computers were added to the depreciation reserve of the appropriate vintage account. Because the depreciation reserve of the vintage account, after the addition of such sales proceeds, was less than the cost basis of the vintage account, petitioner recognized no gain in the year of the sale.

Petitioner continued after 1977 to add the proceeds from the sale of leased computers to the depreciation reserve for the vintage account in which the cost of the computers sold had been recorded. Once the depreciation reserve for a vintage account equaled the cost basis thereof, petitioner reported the entire sales proceeds as ordinary income.

The history of petitioner's reporting for the 1976 and 1977 vintage accounts and the sale of leased computers, the cost of which had been recorded in those accounts, was as follows:

		1976	*1977*
Initial cost basis		$153,250,489	$154,190,709
Additions to depreciation reserve:			
1976:	Depreciation	19,759,916	- - -
	Sales of leased computers	7,815,338	- - -
1977:	Depreciation	35,556,975	19,215,607
	Sales of leased computers	13,030,248	23,082,890
1978:	Depreciation	30,938,502	36,110,302
	Sales of leased computers	10,830,263	20,109,302
1979:	Depreciation	24,519,632	30,221,378
	Sales of leased computers	12,120,412	12,552,129
1980:	Depreciation	- - -	15,727,953
	Sales of leased computers	- - -	0
1981:	Depreciation	(1,320,797)	(2,828,852)
	Sales of leased computers	- - -	0
Total:	Depreciation	109,454,228	98,446,388
	Sales of leased computers	43,796,261	55,744,321
	Total	153,250,489	154,190,709
Proceeds of sales of leased computers taken directly into income:			
	1979	806,854	- - -
	1980	6,242,226	7,119,515
	1981	1,881,645	6,455,575
	1982	2,466,743	4,699,248
	1983	5,266,865	6,465,110
	Total through 1983	16,664,333	24,739,448

The credit to depreciation in 1981 was an internal audit adjustment to correct earlier errors.

Respondent's position is that sales of computers that are leased to customers of petitioner are not "retirements" and that they are not governed by the CLADR regulations. Respondent determined that petitioner's income should be adjusted by adding to sales revenues the selling price of the computers; adding to cost of sales the original cost basis of the computers less depreciation taken; reducing depreciation expense by removing the unadjusted basis of the property sold from the vintage account; and reducing the reserve for depreciation by removing the accrued depreciation for the property sold from the reserve account. The dispute between the parties is over the propriety of the adjustments; the amounts of the adjustments are not in dispute.

Petitioner contends that it followed precisely respondent's regulation set forth above and that, therefore, it is entitled to have its method of treating sales of computers approved. Respondent acknowledges that the regulations have been followed by petitioner but contends that the regulations were not intended to cover the computers sold by petitioner because such computers are "dual purpose property," i.e., property held both for sale and for lease. Thus, argues respondent, sales of the computers by petitioner are not "retirements" under the regulations, and gain on such sales must be computed and reported as they occur.

The concept of "dual purpose property" has been recognized in a series of cases relied on by respondent. *Hollywood Baseball International Shoe Machine Corp. v. United States, 491 F.2d 157* (1st Cir. 1974); *Association v. Commissioner*, 423 F.2d 494 (9th Cir. 1970); *Continental Can Co. v. United States*, 190 Ct. Cl. 811, 422 F.2d 405; *Recordak Corp. v. United States*, 163 Ct. Cl. 294, 325 F.2d 460. These cases stand for the proposition that a manufacturer regularly engaged in the dual business of selling and renting the equipment it manufactures can claim depreciation on property that is at all times available for sale. Proceeds from the sale, however, are treated as ordinary income even though the property might otherwise qualify for capital gain treatment under section 1231. Respondent argues:

> The logical result of this is that sales of dual purpose property are not sales of depreciable property at the time of sale even if the property was under lease just before the sale. Capital gains treatment is unavailable because at the time of the sale the equipment is deemed to have been held primarily for sale to customers in the ordinary course of business. This is the distinguishing factor between the type of retirements involved in petitioner's case and any other sale or exchange of an asset that is not dual purpose property, which would fairly be treated as an "ordinary retirement" under the regulations.
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> It is respondent's position that those sales that should be treated as ordinary retirements are sales of assets that would not be treated as being held primarily for sale to customers when they are sold. * * *

Because "dual purpose property" may be treated as being held for sale at the time of sale, argues respondent, the property is not as of that moment in time held for the production of income or eligible for depreciation. Respondent concludes "accordingly, removal of petitioner's computers from their vintage account can be construed to have been necessitated not by a 'retirement,' but by the failure of the asset to qualify generally as depreciable property under the statute."

In support of his interpretation of the regulations, respondent describes the substantial deferral of recognition of income from sales of property to customers in the ordinary course of business and the basic purpose of the statute and regulations establishing the CLADR system to provide simplicity and ease of application. He argues that section 167(m) was not intended to reverse prior case law defining dual purpose property.

Petitioner relies on its adherence to the literal terms of the regulations and the absence of anything in the regulations supporting respondent's position. According to petitioner, the cases relied on by respondent deal only with the character of the gain recognized and not with the timing of the gain; because the gain ultimately recognized on sale of petitioner's computers will undisputably be ordinary gain, these cases do not provide the authority that respondent seeks. Respondent counters that the cases in question establish a "concept" that we should recognize as inherently keeping petitioner's computers outside of the scope of the regulations.

Answering respondent's arguments about the purposes of the statute and regulations establishing the CLADR system, petitioner argues that its application of the system is consistent with the history and policy of the statute and regulations. Simplicity is served, and because a taxpayer is required to defer recognition of loss as well as gain, the system is not inherently unfair. To the extent that the system is intended to encourage capital investment in depreciable property by providing favorable tax treatment for the property, there is no reason to deny that treatment to petitioner's property. Finally, petitioner asserts "a taxpayer's right to rely on clear and unambiguous regulations." Petitioner argues:

> The IRS drafted the detailed regulations and did not choose to provide for any special treatment for such leased property. The IRS did not publicly state that its position was that a portion of the CLADR regulation would not apply to this leased property until the issuance of

Revenue Ruling 80-37, 1980-1, C.B. 57 [sic], in 1980. Of course, as is discussed below, a revenue ruling cannot overrule a regulation, so the revenue ruling has no effect, but taxpayers were not even put on public notice until 1980 of the possibility the IRS would not follow its own regulations. Even if the revenue ruling did have effect for years after it was issued, it would be an abuse of discretion to apply it retroactively to the years in question since it is a change of position.

Petitioner cites a series of Internal Revenue Service memorandum documents issued in 1979 as indicating that the question of dual purpose property was not considered by the drafters of the regulations, and consideration was given to amending the regulations to expressly cover the situation of dual purpose property. Technical Advice Memorandum 7950005 (Aug. 13, 1979); G.C.M. 38116 (Sept. 28, 1979); see *Rowan Companies, Inc. v. United States*, 452 U.S. 247, 261 n. 17 (1981). Rather than amending the regulations, however, the Internal Revenue Service issued Rev. Rul. 80-37, 1980-1 C.B. 51, containing the arguments now relied on by respondent.

On this issue we conclude that petitioner is entitled to summary judgment in its favor. Respondent's reliance on cases defining dual purpose property as establishing a "concept" to override the express language of his regulations is unpersuasive. Section 1.167(a)-11(d)(3), Income Tax Regs., on its face is comprehensive as to "all retirements from vintage accounts," i.e., permanent withdrawal of the asset "from use in a trade or business or in the production of income by the taxpayer," and "may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment." Petitioner has not challenged, nor do we, respondent's right to amend the regulations to make the distinction between property held solely for use in its leasing business and property held either for lease or for sale. He cannot, however, achieve this result by a revenue ruling or by judicial intervention. See *Woods Investment Co. v. Commissioner*, 85 T.C. 274, 281-282 (1985).

Convertible Debenture Issues

On January 31, 1968, Honeywell Overseas Finance Co. (HOFC) was incorporated under the laws of the State of

Delaware as a 100-percent owned subsidiary of petitioner, with capital of $6 million. HOFC has functioned at all times since its incorporation as a separate corporate subsidiary of petitioner. It was included in the consolidated Federal income tax returns filed by petitioner and its subsidiaries for years beginning in 1968, including 1976 and 1977.

HOFC is what is commonly referred to as an international finance subsidiary. It was formed for the principal purpose of obtaining funds (eurodollars) from overseas sources to be lent to or invested in foreign subsidiaries of petitioner. Petitioner formed the subsidiary in order to avoid subjecting the foreign lenders to (i) U.S. income tax of 30 percent of the interest paid, which tax would have been collected by withholding from the interest otherwise payable to the lenders, and (ii) U.S. estate tax. To avoid withholding and estate taxes, the borrowing corporation must receive less than 20 percent of its income from U.S. sources. (See generally *National Can Corp. v. United States*, 687 F.2d 1107, 1108-1109 (7th Cir. 1982).)

On February 15, 1968, HOFC offered and sold at par $30 million of 15-year, 5-percent debentures. The debentures were exchangeable for petitioner's common stock at $103.25 per share (with cash payable in lieu of fractional shares) from August 15, 1968, through February 15, 1983.

Petitioner engaged Eastman Dillon, Union Securities & Co., to render an opinion with respect to the amount of "discount" attributable to the "conversion" feature of the debentures. In a letter dated July 15, 1969, resulting from that engagement, Eastman Dillon, Union Securities & Co., by a general partner, stated:

> We do not regard the amount of each "discount" as precisely determinable and are unable to make such determination. However, if Honeywell Overseas had in February 1968 sold a non-convertible debenture issue, guaranteed by Honeywell, Inc., we estimate that the issue could have been sold at a 7.35% yield. Using such a yield for computing the discount on the Convertible Debentures, they would have had to be sold at a price of 78.86% to produce a similar yield to maturity. Assuming the maximum value allocated to the conversion feature is the difference between that price and the price at which the Convertible Debentures were sold, the "discount" would be $6,342,000.

Petitioner claims that it is entitled to amortize the sum of $6,342,000 over the 15-year life of the debentures, i.e., deductions of $422,796 per year.

The indenture provided that the debenture holders seeking to exchange their debentures for petitioner's stock would notify and deliver their debentures to the trustee, which would deliver the petitioner's stock in exchange. The stock was to be provided by HOFC unless otherwise agreed by HOFC and petitioner. The indenture also provided that petitioner was required to have stock available to make the exchanges.

Prior to any exchanges, HOFC and petitioner arranged for the exchanges to be made by petitioner using newly issued stock of petitioner. All exchanges were accomplished by a debenture holder exchanging his debenture with petitioner for petitioner's stock and perhaps cash in lieu of fractional shares. HOFC had the use of the capital raised by the debentures from their issuance on February 15, 1968, until their retirement on February 15, 1983. HOFC continued to pay interest on exchanged debentures following the exchanges through February 15, 1983. On February 15, 1983, all debentures not previously exchanged were retired by payment of the face amounts thereof by HOFC to the holders thereof.

Following each exchange, the debentures exchanged were held by petitioner until the February 15, 1983, maturity date of the debentures. On February 15, 1983, the debentures previously exchanged were delivered by petitioner to HOFC in exchange for the payment by HOFC to petitioner of the face amounts thereof.

(1) *Original issue discount.*

Section 1.163-3(a)(1), Income Tax Regs., provides:

> (a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity * * * over the issue price of the bond (as defined in paragraph (b)(2) of sec. 1.1232-3).

Section 1.1232-3(b)(2)(i), Income Tax Regs., provides in part:

> In the case of an obligation which is convertible into stock or another obligation, the issue price includes any amount paid in respect of the conversion privilege. * * *

These regulations reflect the longstanding principle that when a note, bond, or other form of payment obligation is issued in an amount exceeding the proceeds actually received by the borrower, the difference between the two, referred to as the "discount," is deductible as interest. *Helvering v. Union Pacific Railroad Co.*, 293 U.S. 282 (1934).

The above regulations were promulgated on December 23, 1968, to apply to obligations issued after December 31, 1954. T.D. 6984, 1969-1 C.B. 38, 40. Petitioner contends that the regulations cannot be retroactively applied to the HOFC debentures issued February 15, 1968. Rather than dealing directly with the retroactivity question, respondent relies on various cases that, independent of the regulations, have held that a conversion privilege in a debenture does not give rise to an amortizable discount. *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971); *AMF Incorporated v. United States*, 201 Ct. Cl. 338, 476 F.2d 1351; *Hunt Foods & Industries, Inc. v. Commissioner*, 57 T.C. 633 (1972), affd. per curiam 496 F.2d 532 (9th Cir. 1974). Petitioner contends that the cited cases are distinguishable because each one involved a situation in which the debentures were convertible into the stock of the issuer, whereas here the debentures were convertible into the stock of the parent of the issuer.

Petitioner argues that there has been a discount from the purchase price received by the issuer, attributable to the conversion feature, whether the debentures consist of two separate property rights or constitute a single property. In its argument, petitioner refers to the conversion feature as an "exchange privilege," that it purports to distinguish from the usual conversion feature where the issuer of the debenture and the issuer of the stock are the same corporation. In support of this distinction, petitioner argues:

> When a corporation issues debentures that may be converted to the issuing corporation's stock, the debentures may be either exchanged for stock or retained until redeemed or retired. In other words, the debenture has two potential uses; one in the case of the exchange for stock in which

> the debenture holder converts his debt instrument into an equity instrument; and the second, when the debenture holder retains the debt instrument until it is redeemed or retired. This dual-purpose feature of a debenture with a conversion feature for the issuing corporation's own stock is not present in the petitioner's case. HOFC has issued its debentures which may be converted into the stock of its parent, Honeywell. Therefore, even though the original HOFC debenture holder may exchange the debenture for stock of the parent (Honeywell), the parent holds the debenture as a debt instrument until it is redeemed or retired. Thus, at no time does the conversion feature relate to any equity position in the issuing corporation, HOFC. In this situation, the debenture issued by HOFC at a discount represents a cost or expense in acquiring the use of capital to the issuance of the debentures.

We are unpersuaded by petitioner's attempted distinction. Although the debt may remain outstanding even after conversion by the debt holder, the position of the issuer, HOFC, remains the same. HOFC has received the full amount of the proceeds. That the parent may have to comply with the conversion privilege, and that the full amount of the debentures will be due from the issuer, does not reduce the consideration actually received by the issuer. Petitioner argues that the conversion privilege was not sold by the issuer of the debentures "for its own account," but there is no indication that the parent received a part of the proceeds, rather than the issuer.

The rationale in *Chock Full O'Nuts Corp. v. United States*, *supra*, and the cases following it applies a fortiori where, as here, the *issuer* pays no more upon redemption of a debenture than was received on the issuance of the debenture. HOFC does not face any economic loss at the time of conversion, as contrasted to the issuer who may be required to redeem or to convert at the option of the debenture holder. See *Chock Full O'Nuts v. United States*, 453 F.2d at 304. Moreover, the amount deemed to be paid for the conversion feature is not in the nature of interest, i.e., the cost of obtaining capital. See *Chock Full O'Nuts v. United States*, 453 F.2d at 305-306. Thus, the rationale of these cases was extended to the issuance of debentures by a subsidiary convertible into stock of its parent in *National Can Corp. v. United States*, 520 F. Supp. 567, 574-576 (N. D. Ill. 1981), affd. on other issues 687 F.2d 1107 (7th Cir. 1982). Although it may be true, as petitioner argues, that where the same corporation is the issuer of the debentures and of the stock, the total consideration to be paid on conversion is uncertain as of the time of the issuance, the distinction does not undermine the rationale of the controlling authorities.

We therefore conclude that respondent is entitled to prevail as a matter of law on this issue, and that petitioner has no amortizable original issue discount arising from issuance of the HOFC debentures.

(2) *Bond premium.*

Petitioner seeks to deduct as bond premium expense under section 171 the difference between the market value of petitioner's stock at the time of a conversion and the face value of the debentures converted. Again, the theory of deductibility is that the amount, i.e., the premium, is a cost of using the capital. Section 171(b)(1), however, provides that the amount of amortizable bond premium on a convertible bond shall not include any amount attributable to the conversion features of the bond.

The parties agree that this issue was decided adverse to the taxpayer in *National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982). Petitioner argues, however, that *National Can Corp.* was wrongly decided in view of *Commissioner v. Korell*, 339 U.S. 619 (1950).

In *Korell*, the Supreme Court concluded that amortizable bond premium arose under an earlier statutory provision from payment for convertible bonds in excess of the face value of the bonds as a result of a conversion feature in the bonds. The Supreme Court stated:

> We adopt the view that "bond premium" in section 125 means any extra payment, regardless of the reason therefor, in accordance with the firmly established principle of tax law that the ordinary meaning of terms is persuasive of their statutory meaning.
>
> We conclude that Congress made no distinctions based upon the inducements for paying the premium. Congress delimited the bond premium it wished to make amortizable in terms of categories of bonds, and there is no doubt that respondent purchased bonds which are included within the purview of section 125. * * * [*Commissioner v. Korell*, 339 U.S. at 627-628. Fn. ref. omitted.]

Following *Korell*, Congress amended the statutory provision to exclude from amortization of bond premium the amount of a premium paid by the purchaser "attributable to the conversion feature of the bond." This rule was continued as section 171(b)(1) of the Internal Revenue Code of 1954. In *Hanover Bank v. Commissioner*, 369 U.S. 672, 683 (1962), the Supreme Court commented:

> The decision in *Korell* led to congressional re-examination of Section 125, and the enactment of Section 217(a) of the Revenue Act of 1950 (64 Stat. 906), which eliminated amortization of bond premiums attributable to a conversion feature. However, response to the *Korell* decision was specifically limited to the convertible bond situation; no further change was made in the statute which would reflect on its interpretation in the case before us.[17]
>
> ---
>
> 17. The legislation simply provided:
>
> "In no case shall the amount of bond premium of a convertible bond include any amount attributable to the conversion features of the bond."
>
> Where, as in the case before us, a question of interpretation of Section 125 is presented lying outside the scope of the 1950 Amendment, Korell retains its full vitality. * * *
>
> [369 U.S. at 683.]

Petitioner argues that, as a result of the Supreme Court opinions, the term "bond premium" in the applicable statutes is defined as "any extra payment, regardless of the reason therefor." Petitioner would define the exception in section 171(b) as inapplicable here because the debentures are not convertible in the hands of Honeywell, so that Honeywell paid nothing "attributable to" the conversion feature. Petitioner argues that the Court of Appeals for the Seventh Circuit erred in interpreting the phrase "attributable to" to convertible bonds before or after conversion, whereas the intention of the drafters of the legislation responding to *Korell* was merely to differentiate between premium attributable to interest rate considerations and premium attributable to a conversion feature.

Respondent's primary argument is that the amount in question cannot be amortizable bond premium because it did not arise on issuance of the bond, and the payment by the parent must be treated as a contribution of capital from petitioner to HOFC. In resolving the contentions of the parties, it is thus helpful to determine the true nature of the payment. Respondent argues that the amount in question, i.e., the excess of the fair market value of the stock over the par value of the converted debenture, was created and "paid," not because of a variation in the interest rate market, but solely on account of the conversion feature as a function of the stock market. In *National Can Corp v. United States, supra,* the Court of Appeals reasoned that congressional purpose in enacting section 171(b)(1) was to preclude an interest deduction for a stock conversion. 687 F.2d at 1114-1115.

On careful analysis, we believe that respondent's theory more accurately describes the feature to which the payment in question is attributable. At the time of issuance of the debentures, the interest rate market would have affected the determination of the conversion price. After that date, the decision of the holder of a debenture to continue to hold it or to convert it to stock would be affected by both changes in the interest rate and changes in the stock value. But once the stock was worth a sufficient amount in excess of the conversion price, the holders were likely to redeem the debentures. Stock could thereafter be held or converted into interest-bearing assets at the then current market rate. Although the converted debentures were no longer convertible in the hands of the parent, the amount paid by the parent to the redeeming holder was in satisfaction of the holder's conversion privilege and logically is attributable to that privilege and not to additional interest necessary to secure the proceeds of the original issue.

Thus we cannot disagree with the reasoning or the holding of the Court of Appeals in *National Can Corp. v. United States, supra.* Whether the amount in question is described as bond premium but limited by the exception contained in section 171(b) or is not bond premium in the first instance, respondent is entitled to summary judgment as a matter of law on this issue.

An appropriate order will be entered.

ALVARO RAMIREZ, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 12373-85. Filed September 23, 1986.

Under authority of sec. 6851 respondent made a termination assessment against petitioner, a Colombian citizen. Respondent failed to mail a notice of deficiency to petitioner within 60 days of the due date of petitioner's income tax return. Respondent subsequently mailed duplicate notices of deficiency to petitioner. *Held:* Sec. 6851(b) does not constitute a separate period of limitation for the mailing of a notice of deficiency. Therefore, the notices of deficiency mailed to petitioner are valid provided one was mailed to petitioner's last known address. Secs. 6501(a), (c)(3), 6851(b), I.R.C. 1954.

Prior to the mailing of the notices of deficiency, petitioner executed a power of attorney on which he indicated his address was in North Miami Beach, Florida. The power of attorney form used by petitioner included a request that copies of all IRS correspondence be mailed to petitioner's attorney-in-fact. Petitioner did not supply IRS with a mailing address for himself in Colombia. The Commissioner subsequently mailed a notice of deficiency to petitioner at the address shown on the power of attorney, but substituted Miami Beach, Florida, for North Miami Beach, Florida, in the mailing address. The Commissioner also mailed a duplicate notice of deficiency to petitioner at another address, but did not send a copy of the notice of deficiency to petitioner's attorney-in-fact. *Held*, the notice of deficiency was mailed to petitioner's last known address and the petition filed in this case approximately 3 years after the mailing of the notice of deficiency is untimely. Secs. 6212(b), 6213(a), I.R.C. 1954.

Sidney A. Soltz, for the petitioner.
Susan Wynne, for the respondent.

GOFFE, *Judge*: This case is before us on respondent's motion to dismiss for lack of jurisdiction based upon the petition's being filed more than 3 years after the mailing of the statutory notice of deficiency. We must now decide if a statutory notice of deficiency, mailed subsequent to a termination assessment by the Commissioner, but not within the specified period set forth in section 6851(b),[1] deprives this Court of jurisdiction. If not, we must also decide whether the statutory notice of deficiency was mailed to petitioner at his "last known address" within the meaning of section 6212(b).

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the relevant years, and all Rule references are to the Rules of Practice and Procedure of this Court.

FINDINGS OF FACT

Alvaro Ramirez (petitioner) resided in Bogota, Colombia, South America, at the time he filed his petition in this case.

On August 8, 1980, the District Director of Internal Revenue terminated petitioner's taxable year effective July 3, 1980, and assessed income tax in the amount of $1,990,271 under the provisions of section 6851. On August 11, 1980, the District Director mailed a letter to petitioner at 17011 N. Bay Road, Apt. 119, Miami Beach, Florida 33160, notifying petitioner that he had ordered a termination assessment against petitioner under section 6851 for the taxable period from January 1, 1980, to July 3, 1980, in the amount of $1,990,271.

On August 14, 1980, petitioner executed a power of attorney appointing Sidney A. Soltz and another person as his attorneys-in-fact with regard to his income tax liability arising out of the "termination assessment for the period ended July 3rd, 1980." The preprinted IRS power of attorney form executed by petitioner included the following provision:

> Copies of notices and other written communications addressed to the taxpayer(s) in proceedings involving the above matters should be sent to * * *:
>
> Sidney A. Soltz, Esq.
> 19 West Flagler Street
> Miami, Florida 33130 phone: (305) 358-5157

Petitioner gave 17011 North Bay Road, Apt. 200, North Miami Beach, Florida 33160, as his address on the power of attorney form.

After exhausting his administrative remedies, petitioner brought a civil action against the United States in U.S. District Court for the Southern District of Florida to challenge the termination assessment under section 7429(b). In its order dated December 5, 1980, finding the termination assessment proper, the District Court said in part:

> [the foregoing] points toward and corroborates plaintiff's personal liability for income tax and is sufficient to justify the use of the termination assessment procedures and provides a reasonable basis for the making and issuance of the termination assessment against plaintiff in this case. There was a strong likelihood that plaintiff would flee the country, as he has in fact done, which indicated that collection of the tax liability was in jeopardy and justified the action by the Government. * * *

The District Court also noted that respondent conceded that petitioner's assessed tax liability must be reduced from $1,990,271 to $1,613,129 because of an error in calculating the correct amount of tax. The Commissioner had not mailed a statutory notice of deficiency to petitioner with respect to the taxable year 1980 at the time of the District Court's ruling.

On May 10, 1982, the Commissioner mailed duplicate statutory notices of deficiency in which he determined a deficiency in petitioner's income tax liability for the taxable year 1980. The deficiency was the same amount, less small reductions allowed by the Commissioner, that was assessed against petitioner pursuant to the termination of his taxable year, plus additions to tax under sections 6651(a)(1), 6653(a), and 6654. Duplicate originals were mailed to petitioner by certified mail in separate envelopes addressed as follows:

17011 North Bay Road
Apartment 200
Miami Beach, Florida 33160

17011 North Bay Road
Apartment 119
Miami Beach, Florida 33160

On May 19, 1982, both envelopes were returned by the postal service stamped to indicate that petitioner had moved and left no forwarding address.

On January 12, 1983, petitioner's attorney, Soltz, wrote the following letter to the District Director and enclosed a copy of the power of attorney executed by petitioner on August 14, 1980:

> Re: Alvaro Ramirez
> Termination Assessment
> 1/01/80 through 7/03/80
>
> Dear Sir:
>
> Enclosed herewith find copy of Power of Attorney authorizing the undersigned to represent Mr. Ramirez in connection with the above matter. The original was previously filed with the Internal Revenue Service sometime in 1980.

> It would be appreciated if you could advise this office as soon as possible whether or not a Statutory Notice (90-Day Letter) was ever issued in this matter and if so, it is requested that a copy be sent to the undersigned.

In a subsequent telephone conversation, an IRS representative informed Soltz that a notice of deficiency had been mailed, but that the representative no longer retained a copy.

Soltz filed an income tax return for the full taxable year 1980 on behalf of petitioner although the date of filing is unknown.

In January 1984, the Commissioner mailed to petitioner a request for payment of taxes for the taxable year 1980. This request was mailed to petitioner at the following address: Alvaro Ramirez, c/o Sidney A. Soltz, 19 W. Flagler Street, Miami, Florida 33130.

On May 13, 1985, petitioner filed his petition in this case, more than 3 years after the mailing of the duplicate notices of deficiency. Respondent filed original and amended motions to dismiss for lack of jurisdiction on July 12, 1985, and July 16, 1985, respectively. Petitioner filed objections to the original and amended motions of respondent and the Court held a hearing at Miami, Florida, at which time the parties made oral arguments and offered the testimony of witnesses and exhibits.

OPINION

Congress delegated to the Commissioner authority to immediately assess income tax liabilities when the collection thereof is in jeopardy. This extraordinary power, found in sections 6851 and 6861, is an exception to the usual procedure whereby assessment can be made only after a notice of deficiency is mailed and the taxpayer is given a prepayment opportunity to petition this Court for a redetermination of the deficiency. Secs. 6212, 6213. Provided other prerequisites are satisfied, a termination assessment under section 6851 is the appropriate tool whenever the collection of income tax is found to be jeopardized at any time during the current taxable year or the immediately preceding taxable year. A jeopardy assessment under section 6861 is appropriate after the due date for the taxpayer's return for the previous year. See sec. 6851(a)(4).

The power to assess under section 6851 may be used whenever the Commissioner finds that there is an imminent danger that the taxpayer, by leaving the country, concealing his property, or otherwise, will prevent effective proceedings to collect income tax. After finding the requisite peril to the effective collection of income tax, the Commissioner is empowered by section 6851 to terminate the taxpayer's taxable year and immediately assess the tax due. However, the termination of the taxable year under section 6851 does not create 2 short taxable years; the taxable year of the taxpayer remains the same. Staff of J. Comm. on Taxation, General Explanation of Tax Reform Act of 1976, at 363 (J. Comm. Print 1976) (hereinafter referred to as General Explanation). The "termination" of the taxable year under section 6851 is a technical one; any amounts assessed and paid thereunder are treated in a manner similar to those collected as estimated tax payments for the full calendar taxable year. General Explanation, *supra*.

Although Congress has granted the Commissioner great powers in jeopardy situations, these powers are tempered by the opportunity of the taxpayer for administrative and summary judicial review found in section 7429. Under section 7429, which was enacted as part of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1520, the Commissioner must provide the taxpayer with written notification of and the basis for the jeopardy or termination assessment. Sec. 7429(a)(1). The taxpayer may then pursue an administrative review of the reasonableness of the assessment. Sec. 7429(a)(2), (3). After exhausting the opportunity for administrative review, the taxpayer may bring a civil action against the United States in U.S. District Court. If the District Court finds the assessment to have been unreasonable under the circumstances it is empowered to order the Commissioner "to abate such assessment, to redetermine * * * the amount assessed or demanded, or to take such other action as the court finds appropriate." Sec. 7429(b)(3). The authority to bring suit under section 7429(b) is an exception to the general prohibition against suits to restrain the assessment or collection of taxes. Sec. 7421(a).

Although a taxpayer must challenge the propriety of a termination or jeopardy assessment in the District Court under section 7429(b), Congress has made clear that access to the Tax Court to litigate the tax liability of the taxpayer on the merits is not to be foreclosed. Secs. 6851(b), 6861(b). Furthermore, access to this forum, predicated upon the mailing of a notice of deficiency, is to be provided promptly.

Following a termination assessment under section 6851, the Commissioner is required to mail a notice of deficiency within 60 days of the later of (1) the due date of the taxpayer's return for the full taxable year during which the termination assessment was made or (2) the date the taxpayer files such return. Sec. 6851(b). The notices of deficiency were mailed on May 10, 1982, clearly more than 60 days after the due date for petitioner's 1980 return. Petitioner's attorney filed a return on his behalf but no evidence was offered as to when the return was filed. Even if the return was timely filed, the period of limitations on assessment would not have expired under section 6501 on May 10, 1982, when the statutory notices were mailed. Nevertheless, petitioner contends that because the Commissioner did not mail a notice of deficiency within 60 days of the due date of his return, the notice of deficiency was invalid regardless of his failure to file a return.[2] We conclude that even if the notice of deficiency was untimely under section 6851(b), our jurisdiction in this case is unaffected.

Petitioner's arguments affect our jurisdiction only if the accelerated time table for the issuance of a notice of deficiency constitutes a statute of limitations separate from the general 3-year period of limitations found in section 6501. In a similar case involving a jeopardy assessment under section 273(b) of the Internal Revenue Code of 1939, now section 6861, we held that the accelerated period provided for issuing the notice of deficiency under section

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[2] In support of this argument petitioner cites the decision of the Court of Appeals for the Ninth Circuit in *Perlowin v. Sassi*, 711 F.2d 910 (9th Cir. 1983). In *Perlowin*, the Court of Appeals affirmed the findings of the District Court that sec. 6851(b), requiring the issuance of a notice of deficiency within 60 days of the *later* of the due date of the taxpayer's return or the date such return is actually filed, is ambiguous in the case of a taxpayer who fails to file a return, and held that in the case of a nonfiling taxpayer the Commissioner must send a notice of deficiency within 60 days of the due date for the taxpayer's return covering a year in which a termination assessment is made. 711 F.2d at 912.

6861(b) was not jurisdictional. *Teitelbaum v. Commissioner*, 40 T.C. 223 (1963). In *Teitelbaum* we concluded:

> The involved statute is by legislative history, H. Rept. No. 356, 69th Cong., 1st Sess. (1926), 1939-1 C.B. (Part 2) 370, intended to be, not a limitation upon the allowable period for respondent's issuance of a deficiency notice, but is rather, as contended by respondent, a limitation upon the conditions under which respondent may maintain and keep in force a jeopardy assessment made prior to his issuance of a deficiency notice. * * * The mere fact that a jeopardy assessment may be illegal has no bearing upon the jurisdiction of this Court to adjudicate liability for the correct tax. [40 T.C. at 227.]

We find the same statement applicable to the requirement that a notice of deficiency be mailed following a termination assessment under section 6851. The legislative history of section 6851(b) makes clear that the taxpayer's opportunity to receive a notice of deficiency following a termination assessment was designed to place such taxpayers on equal footing with taxpayers who had been subjected to a jeopardy assessment under section 6861. S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 405. Because the notices of deficiency were mailed to petitioner well within the 3-year period of limitations,[3] a petition filed more than 90 days after the date the notice was mailed is untimely and we must grant respondent's motion to dismiss unless the notice was otherwise invalid.[4]

We now turn to petitioner's claim that the notices of deficiency mailed on May 10, 1982, were not addressed to petitioner's "last known address" within the meaning of section 6212(b). If we find that the notices were mailed to petitioner's last known address, then we must grant respondent's motion to dismiss for lack of jurisdiction because of the untimeliness of the petition. *Weinroth v. Commissioner*, 74 T.C. 430, 434-435 (1980).

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[3] We note that under sec. 6501(c)(3) the 3-year period of limitations did not begin to run until such time as the petitioner filed an income tax return for the taxable year 1980.

[4] At the hearing on the motion before us, petitioner seemed to request that we abate the termination assessment because the Commissioner failed to mail the notice of deficiency within 60 days of the due date of his return in accord with *Perlowin v. Sassi*, *supra*. We have no jurisdiction to do so. See sec. 7429. Petitioner should have raised any procedural defects in the termination, namely the failure of the Commissioner to mail the notice of deficiency, in the proceeding before the District Court. If the District Court found the failure to mail a notice of deficiency within 60 days of the due date of petitioner's return to be a procedural defect in the termination assessment, it could have ordered the assessment abated or, more likely, issued an injunction preventing further collection efforts under the assessment until a notice of deficiency was issued. See, *e.g.*, *L.O.C. Industries, Inc. v. United States*, 423 F. Supp. 265 (M.D. Tenn. 1976). By taking up his claim with the District Court petitioner would have obtained the protections from unreasonable assessments provided in sec. 7429 and would have obtained his "ticket to the Tax Court" allowing him to litigate his 1980 tax liability on the merits. See *Musso v. Commissioner*, 531 F.2d 772 (5th Cir. 1976), affg. a Memorandum Opinion of this Court. As it stands, respondent ultimately mailed a notice of deficiency to petitioner and, therefore, he was not denied access to this forum to litigate his tax liability on the merits.

For purposes of section 6212(b)(1) a taxpayer's last known address is the address, determined by a consideration of all relevant circumstances, which respondent reasonably believes the taxpayer wishes to have respondent use in sending mail to him. *Clark's Estate v. Commissioner*, 173 F.2d 13 (2d Cir. 1949); *Lifter v. Commissioner*, 59 T.C. 818, 821 (1973). To be sufficient under section 6212(b), the taxpayer need not actually receive a notice of deficiency if it is mailed to the taxpayer's last known address. Although the Commissioner must exercise reasonable diligence in ascertaining the taxpayer's correct address (*Arlington Corp. v. Commissioner*, 183 F.2d 448, 450 (5th Cir. 1950), revg. and remanding a Memorandum Opinion of this Court), the burden necessarily falls upon the taxpayer to keep the Commissioner informed of his correct address. *Alta Sierra Vista, Inc. v. Commissioner*, 62 T.C. 367, 374 (1974), affd. without published opinion 538 F.2d 334 (9th Cir. 1976). Ordinarily, unless the taxpayer clearly gives notice of a different address, the Commissioner may rely upon the address shown on the tax return for the year to which the deficiency relates. *Lifter v. Commissioner, supra*. However, there is no evidence before us to show when petitioner's return was filed. The return bears a Bogota, Colombia, address. Therefore, we must examine all of the information available to the Commissioner when the notices of deficiency were mailed to petitioner at two Miami addresses.

The District Director mailed the notice of termination assessment required under section 7429(a) to petitioner at 17011 N. Bay Road, Apt. 119, Miami Beach, Florida 33160, on August 11, 1980. The fact that petitioner received this notice, either personally or by someone acting on his behalf, is clearly demonstrated by the fact that petitioner promptly executed a power of attorney appointing attorneys-in-fact to represent petitioner with respect to the termination assessment. This power of attorney reflected a different apartment number, 17011 N. Bay Road, Apt. 200, and city, *North* Miami Beach rather than Miami Beach. The Commissioner was aware no later than December 5, 1980, the date of the order of the District Court upholding the reasonableness of the termination assessment, that petitioner had left the United States for Colombia. However, petitioner did not notify the Commissioner of any new address at which he desired to receive correspondence. The Commissioner did not have an address for petitioner in Colombia until his attorney filed the 1980 income tax return. The date of filing that return is not in evidence. We suspect that the return was filed long after the notices of deficiency were mailed.

Based on the foregoing we conclude the notice of deficiency addressed to petitioner at 17011 N. Bay Road, Apt. 200, Miami Beach, Florida, was properly mailed to petitioner at his last known address. In this regard, we note that the address given for petitioner in the power of attorney was in *North* Miami Beach, while the notices of deficiency were addressed to petitioner in Miami Beach, Florida. However, the street address, apartment number, and zip code were identical. Moreover, petitioner, who had left the country when the notices of deficiency were mailed, has not demonstrated that he would have received a notice of deficiency mailed to him at North Miami Beach. On these facts, we do not think that petitioner was prejudiced by this minor discrepancy even though he failed to file a timely petition. See *Looper v. Commissioner*, 73 T.C. 690, 698-699 (1980).

Our holding on this issue necessarily implies that respondent used reasonable diligence in ascertaining petitioner's address for purposes of mailing the notices of deficiency. Although the IRS knew at some unknown point in time when the return was filed that petitioner no longer resided in the United States, the IRS, nevertheless, could have contacted petitioner's attorney in an attempt to ascertain petitioner's current address. However, this, standing alone, together with the lack of evidence as to the filing date of the return, does not convince us that respondent failed to use reasonable diligence in ascertaining petitioner's new address. Therefore, respondent mailed duplicate notices of deficiency to the only mailing addresses of petitioner reflected in the administrative files. Moreover, petitioner left the country and did not provide respondent with a new address.

Despite our holding, we admit some distress at the failure of the IRS to mail *copies* of the notices of deficiency to petitioner's counsel of record in accordance with the request found in a valid power of attorney. One of the reasons stated for not supplying the requested copies was that the power of attorney executed by petitioner covered only the terminated taxable period rather than the full tax year covered by the notice of deficiency. Inasmuch as the IRS knew or should have known that the so-called short taxable year created by a termination assessment is a fiction that does not alter the actual taxable year of the taxpayer, we find this excuse implausible. Another, more plausible, reason given for failing to mail copies to petitioner's attorney was that the IRS construed a power of attorney covering the "termination assessment for the period ended July 3rd, 1980" as being given only for the purpose of representing petitioner before the IRS in the administrative review of such assessments under section 7429. We also note that a request for payment of taxes was sent to petitioner at his attorney's office, albeit almost 2 years following the mailing of the notices of deficiency. In any event, a request in a power of attorney that *copies* of all relevant documents be sent to petitioner's attorney-in-fact has consistently been interpreted as merely a matter of courtesy and not petitioner's last known address to which an original notice of deficiency must be sent. *Estate of McElroy v. Commissioner*, 82 T.C. 509, 513 (1984); *Houghton v. Commissioner*, 48 T.C. 656, 661 (1967); *Allen v. Commissioner*, 29 T.C. 113, 117 (1957); but see *Johnson v. Commissioner*, 611 F.2d 1015, 1020 (5th Cir. 1980),[5] revg. and remanding a Memorandum Opinion of this Court.

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[5] In *Johnson v. Commissioner*, 611 F.2d 1015 (5th Cir. 1980), revg. and remanding a Memorandum Opinion of this Court, the Fifth Circuit held that the Commissioner had not used reasonable diligence to ascertain the taxpayer's last known address. We find the facts in *Johnson* to be easily distinguishable from those before us. In *Johnson*, the taxpayer submitted a power of attorney, which substituted a new address. The IRS misplaced the power of attorney and, as a result, mailed the notice of deficiency to the taxpayer's old address. This error was exacerbated by the fact that the taxpayer orally notified the IRS of his change in address. Finally, the Court relied upon the fact that a concurrent criminal investigation of the taxpayer provided the IRS with sufficient notice of the taxpayer's change of address. These factors are not present in the case before us. See *Foster v. Commissioner*, T.C. Memo. 1982-115. Furthermore, the Fifth Circuit was careful to limit its decision in *Johnson* to its particular facts:

Because petitioner filed a petition with this Court more han 90 days following the mailing of a timely notice of leficiency mailed to him at his last known address, the etition is insufficient to confer jurisdiction upon this Court. ec. 6213(a). Accordingly, respondent's motion to dismiss is ranted. To reflect the foregoing,

An appropriate order will be entered.

ESTATE OF ANTHONY F. DiMARCO, DECEASED, JOAN M. DiMARCO, PERSONAL REPRESENTATIVE, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 18965-83. Filed September 24, 1986.

Decedent's spouse was paid a survivors income benefit pursuant to a plan that was established and maintained by decedent's employer. Under the terms of the plan, the survivors income benefit was payable by decedent's employer only to decedent's eligible survivors upon his death. Decedent's participation in the plan was involuntary. He had no power to select or change the beneficiaries of the survivors income benefit; no power to change the amount, form, or timing of the survivors income benefit payments; no power to substitute other benefits for the survivors income benefit; and, other than by resigning his employment, no power to terminate his coverage under the plan. In addition, decedent's employer reserved the right, in its discretion, to modify the plan at any time. *Held*, decedent did not make a taxable gift of the survivors income benefit to his spouse within the meaning of sec. 2503, I.R.C. 1954, and the present value of the survivors income benefit is not, therefore, an adjusted taxable gift within the meaning of sec. 2001, I.R.C. 1954.

John M. Vine and *David N. Heap*, for the petitioner.
Warren P. Simonsen, for the respondent.

"We wish to emphasize that our holding is narrowly limited to the peculiar facts and ircumstances of this case and is not meant as authority for requiring the Commissioner to dopt new procedures for sending statutory notices of deficiency. * * * [611 F.2d at 1021.]"

In any event, an appeal in the instant case would lie in the U.S. Court of Appeals for the District of Columbia because petitioner resided in Bogota, Colombia, when he filed his petition erein. Sec. 7482(b).

OPINION

STERRETT, *Chief Judge*: By notice of deficiency dated May 4, 1983, respondent determined a deficiency in petitioner's Federal estate tax of $17,830.88. As a result of concessions by both parties,[1] the only issue presented in this case is whether the present value of a survivors income benefit payable with respect to the decedent by decedent's employer is an adjusted taxable gift within the meaning of section 2001.[2]

The parties submitted this case fully stipulated pursuant to Rule 122. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner is the Estate of Anthony F. DiMarco, Joan M. DiMarco, personal representative. Joan M. DiMarco is and at all relevant times has been the sole personal representative of petitioner. At the time the petition was filed in this case, Joan M. DiMarco resided in Wappingers Falls, New York. The Federal estate tax return of Anthony F. DiMarco was filed with the Office of the Internal Revenue Service at Andover, Massachusetts.

Anthony F. DiMarco (hereinafter referred to as the decedent) was born on August 31, 1925. He died on November 16, 1979, survived by his wife, Joan M. DiMarco, and five children. He had been employed continuously by the International Business Machines Corp. (IBM) as an active, regular, full-time, permanent employee from January 9, 1950, until his death. On May 2, 1953, decedent and Joan M. DiMarco were married; he had not been previously married. Decedent's parents were not dependent upon him for their support at any time between the date when his employment with IBM began and the date of his marriage to Joan M. DiMarco. At the time of his death, decedent was employed as an electrical engineer at a salary of $5,250 per month. He was not an officer of the corporation and did not have a written employment contract.

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[1] Petitioner concedes that minor adjustments made by respondent to the value of decedent's gross estate and debts are correct, and respondent concedes that the gift tax exclusion provided by sec. 2503 is allowable in computing the amount of the deficiency, if any is redetermined.

[2] Unless otherwise indicated, all sections referred to are sections of the Internal Revenue Code of 1954 as amended and in effect at the time of decedent's death, and all Rules referred to are the Rules of Practice and Procedure of this Court.

On November 16, 1979, and at all other times relevant to this proceeding, IBM maintained a noncontributory Group Life Insurance and Survivors Income Benefit Plan (hereinafter referred to as the plan) for the benefit of its regular employees. IBM established the plan in September of 1934, and while the plan has been amended on many occasions since that time, it has, since January of 1935, provided two basic benefits: (i) group term life insurance, and (ii) an uninsured and unfunded survivors income benefit.

The plan provided group term life insurance pursuant to a group contract between IBM and the Prudential Life Insurance Co. of America. The amount of insurance payable under the plan was dependent on the length of the employee's service with the company.

The plan also provided a survivors income benefit on an uninsured and unfunded basis; that is, all survivors income benefits were paid out of IBM's general assets. With the exception of fewer than 30 top executives, all regular IBM employees, including decedent, were covered automatically by the survivors income benefit portion of the plan. At the time of decedent's death, the amount of the survivors income benefit was equal to three times the employee's regular annual compensation. Under the terms of the plan, the benefit was payable only to an employee's surviving spouse, certain minor and dependent children, and dependent parents. Payment was made semimonthly, at the monthly rate of one-quarter of the employee's regular monthly compensation, and continued until the total benefit was paid. However, payments continued only so long as there remained at least one eligible survivor, and if the employee left no eligible survivor at death, no benefit was payable.

Decedent never had any power to alter, amend, revoke, or terminate the plan in whole or in part. He had no power to select or change the beneficiaries of the survivors income benefit; no power to change the amount, form, or timing of the survivors income benefit payments; no power to substitute other benefits for the survivors income benefit; and, other than by resigning his employment with IBM, no power to terminate his coverage under the plan. However, IBM expressly reserved the right, in its discretion, to modify the plan if it determined that it was advisable to do so.

Joan M. DiMarco, as decedent's surviving spouse, was entitled under the plan to receive a survivors income benefit, payable semimonthly, in the amount of $656.25.[3] Decedent did not report the survivors income benefit as a gift on a gift tax return, and petitioner did not report it either as part of the gross estate or as an adjusted taxable gift on decedent's Federal estate tax return. However, the existence of the survivors income benefit was reported by petitioner on Schedule I of decedent's Federal estate tax return.

In his notice of deficiency, respondent "determined that an adjusted taxable gift of the present value of the IBM Survivor Annuity was made by the decedent on the date of death as it was not susceptible of valuation until the date of death." Respondent then determined that the present value of the survivors income benefit was $135,885,[4] and he added this amount, as an adjusted taxable gift, to the taxable estate of decedent in computing the amount of the deficiency.

The only issue for decision in this case is whether the present value of the survivors income benefit that is payable by IBM to Joan M. DiMarco is an adjusted taxable gift within the meaning of section 2001. The term "adjusted taxable gifts" is defined by section 2001(b) as "the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includable in the gross estate of the decedent."[5] Section 2503(a) in turn defines "taxable gifts"

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[3] Under the terms of the plan, decedent's surviving spouse was entitled to receive these semimonthly payments until her death, remarriage, or the exhaustion of the total amount of the survivors income benefit. If she died or remarried prior to the exhaustion of the fund, the semimonthly payments would be continued to decedent's other eligible survivors.

[4] Petitioner does not dispute that this value represents the present value of the survivors income benefit.

[5] Sec. 2001 provided, in pertinent part, as follows:

SEC. 2001. IMPOSITION AND RATE OF TAX.

(a) IMPOSITION.—A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

(b) COMPUTATION OF TAX.—The tax imposed by this section shall be the amount equal to the excess (if any) of—

(1) a tentative tax computed in accordance with the rate schedule set forth in subsection (c) on the sum of—

(A) the amount of the taxable estate, and as the "total amount of gifts" made during the applicable period less certain statutory deductions.[6] Thus, the survivors income benefit that is payable by IBM to Joan M. DiMarco is an adjusted taxable gift within the meaning of section 2001 only if it is also a taxable gift within the meaning of section 2503 that was made by decedent after December 31, 1976.

We begin our analysis by noting that it is unclear precisely what respondent argues in this case. On brief, he proposes that we adopt as an ultimate finding of fact that "Decedent made a completed gift of the Survivor's Benefit to unnamed beneficiaries upon the commencement of his employment on January 9, 1950." Two pages later in the same brief he argues that "the transfer should be treated as a completed gift in 1979." In the statutory notice of deficiency and the stipulation of facts, respondent appears to take the position that decedent actually made a completed gift of the survivors income benefit at the time of his death in 1979. Respondent finally attempts to clarify his position by stating in his reply brief that it is his "position that the gift of the Survivor's Benefit occurred in 1950 and the inability to value said gift requires * * * [respondent] to treat the gift as complete on the date of death when the gift finally became subject to valuation."

After reviewing carefully respondent's briefs, the statutory notice of deficiency, and the stipulation of facts, it appears to us that respondent is making two arguments in this case. First, it appears that respondent argues that decedent made a completed transfer of a property interest in the survivors income benefit for gift tax purposes on January 9, 1950, but that because the interest could not be

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(B) the amount of the adjusted taxable gifts, over

(2) the aggregate amount of tax payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976.

For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

[6] Sec. 2503(a) provided:

SEC. 2503. TAXABLE GIFTS.

(a) GENERAL DEFINITION.—The term "taxable gifts" means, in the case of gifts made after December 31, 1970, the total amount of gifts made during the calendar quarter, less the deductions provided in subchapter C (sec. 2521 and following). In the case of gifts made before January 1, 1971, such term means the total amount of gifts made during the calendar year, less the deductions provided in subchapter C.

valued at that time, it was necessary to treat the transfer as an open transaction and to value the transferred property and impose the gift tax on the date of decedent's death, when the property interest finally became subject to valuation. In the alternative, respondent appears to argue that decedent made an incomplete transfer of a property interest in the survivors income benefit for gift tax purposes on January 9, 1950, because the property interest could not be valued at that time, but that the transfer became complete on November 16, 1979, when decedent died, because the transferred property could then and for the first time be valued.

Petitioner argues, for a variety of reasons, that decedent never made a taxable gift of the survivors income benefit. Petitioner argues that decedent never owned a property interest in the survivors income benefit that he was capable of transferring. Petitioner further contends that, even if decedent owned such an interest, he never transferred it, and if he did transfer it, he never did so voluntarily. Petitioner also asserts that transfers of property cannot become complete for gift tax purposes upon the death of the donor, and that decedent never made a completed transfer of any property interest he may have owned in the survivors income benefit before his death because he always had the power to revoke the transfer, if any was made, simply by resigning his employment with IBM. Petitioner finally argues that, if the decedent made a taxable gift of the survivors income benefit, he did so before December 31, 1976, and that such a gift does not qualify as an adjusted taxable gift within the meaning of section 2001. For the reasons set forth below, we find for petitioner.

Section 2501(a)(1) imposes a tax on the "transfer of property by gift." Section 2511(a) provides that the tax "shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." However, a transfer of property qualifies as a taxable gift only if the transfer is complete, and a transfer is complete for gift tax purposes only when the transferor relinquishes dominion and control over the transferred property. Sec. 25.2511-2(b), Gift Tax Regs.; *Estate of Sanford v. Commissioner,* 308 U.S. 39, 42-43 (1939). At the time the transfer is complete, the transferred property must be valued. Sec. 2512(a). This value is then used in determining the gift tax that is due. Sec. 2502.

Respondent argues that decedent transferred a property interest in the survivors income benefit for gift tax purposes on January 9, 1950. This transfer was either complete or incomplete for gift tax purposes. If the transfer was complete, we have little difficulty in disposing of this case because a completed transfer would have been a taxable gift that was made by decedent before December 31, 1976, and section 2001 expressly defines an adjusted taxable gift as a taxable gift that was made after December 31, 1976. On the other hand, if the transfer was incomplete for gift tax purposes, we do not believe that it became complete or that we can deem that it became complete at the time of decedent's death.[7] Section 25.2511-2(f), Gift Tax Regs., provides that—

> The relinquishment or termination of a power to change the beneficiaries of transferred property, *occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors)*, is regarded as the event that completes the gift and causes the tax to apply. * * * [Emphasis added.]

We believe that this regulation precludes our finding in this case that the alleged transfer of property by decedent on January 9, 1950, became complete for gift tax purposes by reason of decedent's death.

We recognize, of course, that respondent does not assert in this case that the alleged transfer on January 9, 1950, became complete and subject to the gift tax because decedent's death terminated a power to change the beneficiaries of the transferred property. Even so, in view of the fact that a transfer of property that becomes complete because the donor's death terminates a power to change the beneficiaries of the transferred property is not subject to the gift tax, we decline to hold that a transfer of property that becomes complete because the donor's death makes it possible for the first time to value the transferred property is subject to the gift tax. We perceive nothing in the gift tax statute or the regulations that would justify such result.

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[7] Respondent does not assert that the transfer became complete for gift tax purposes at any time other than Jan. 9, 1950, or Nov. 16, 1979.

In addition, we believe that respondent has confused th issues of completion and valuation in this case. Responden appears to argue that, because the value of the survivor income benefit could not be determined on January 9, 195(when the alleged transfer occurred, the transfer should b treated as incomplete for gift tax purposes until th survivors income benefit became susceptible of valuatio when decedent died, at which time the transfer becam complete and subject to the gift tax. For the reasons state above, we have already held that transfers of property d not become complete for gift tax purposes by reason of th death of the donor. We also question, however, whether th fact that the value of transferred property cannot be readil determined at the time of transfer is relevant in determi ing whether the transfer is complete for gift tax purpose We have noted above that transfers of property a complete and subject to the gift tax at the time the don relinquishes dominion and control over the transferre property. Nothing in the statute or the regulations suggest that, even if a donor relinquishes dominion and control ov transferred property, the transfer is or can be considered t be incomplete for gift tax purposes if the value of th property is uncertain. To the contrary, in *Smith* *Shaughnessy*, 318 U.S. 176, 180 (1943), the Supreme Cou appears to have considered and expressly rejected th argument in the following language:

> The government argues that for gift tax purposes the taxpayer h abandoned control of the remainder and that it is therefore taxable, wh the taxpayer contends that no realistic value can be placed on t contingent remainder and that it therefore should not be classed as gift.
>
> We cannot accept any suggestion that the complexity of a proper interest * * * can serve to defeat a tax. * * * Even though these co cepts of property and value may be slippery and elusive they can n escape taxation so long as they are used in the world of business. T language of the gift tax statute, "property * * * real or person tangible or intangible," is broad enough to include property, howev conceptual or contingent. * * *

Accordingly, we reject any suggestion by respondent eith that transfers of property are incomplete for gift t purposes simply because "no realistic value can be placed" on the property at the time the transfer occurs, or that transfers of property become complete for gift tax purposes only when the value of the transferred property can be easily ascertained.

Respondent also argues that completed transfers of property for gift tax purposes can and should be treated as open transactions in those cases where the transferred property is difficult to value, and that valuation of the transferred property and the imposition of the gift tax should be postponed until the value of the property can be readily determined. We reject this contention. The clear language of the statute and the regulations requires that transferred property be valued for gift tax purposes at the time the transfer becomes complete. Section 2512(a) provides that, in the case of a gift, "the value thereof at the *date of the gift* shall be considered the amount of the gift." (Emphasis added.) In addition, section 25.2511-2(a), Gift Tax Regs., states as follows:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer * * * . On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his *act of making the transfer, [and] is measured by the value of the property passing from the donor* * * * [Emphasis added.]

As a result, property must be valued and the gift tax imposed at the time a completed transfer of the property occurs.[8]

We also agree with petitioner that decedent never made a taxable gift of any property interest in the survivors income benefit because we find no act by decedent that qualifies as an act of "transfer" of an interest in property. His participation in the plan was involuntary, he had no power to select or change the beneficiaries of the survivors income benefit, no power to alter the amount or timing of the payment of the benefit, and no power to substitute other benefits for those prescribed by the plan. These facts are substantially similar to the facts of *Estate of Miller v. Commissioner*, 14 T.C. 657 (1950), an estate tax case wherein we also concluded that the decedent had performed no qualifying act of transfer. In *Estate of Miller*, respondent argued, relying on cases where the decedent had purchased for a lump sum, joint and survivor annuity contracts and at the time of purchase irrevocably designated the surviving annuitants, that the decedent had, for purposes of section 811(c) of the 1939 Code, transferred property during his life that was intended to take effect at his death. We rejected this contention and concluded that the decedent could not have transferred any property interest for any purpose because he had not performed any act that possibly could be construed as an act of transfer. We stated as follows:

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[8] Respondent relies heavily on Rev. Rul. 81-31, 1981-1 C.B. 475, and argues here that we should adopt its reasoning and holding. To the extent that this ruling can be read as holding either that a transfer of property can become complete for gift tax purposes by reason of the death of the donor, or that it is permissible to treat a completed transfer of property as an open transaction and to value the transferred property and impose the gift tax at some time other than when the completed transfer occurs, we regard the ruling as being inconsistent with the gift tax statute and the regulations.

> we find no act on the part of the decedent which we think can properly be characterized as a "transfer" of an interest in property. Unlike the purchase of the annuity contracts in the *Wilder, Clise*, and *Mearkle* cases, the decedent's participation in the pension plan inaugurated by his employer was not voluntary. The plan itself nominated the surviving beneficiaries, limiting them to the wife or the minor children of the officer or employee. Decedent, other than by continuing in his employment at the bank, which incidentally he had enjoyed for 13 years prior to the establishment of the plan, had no part in the selection of his wife as a surviving pensioner. Nor did he personally possess any means of defeating her pension rights other than by resigning his position at the bank. * * * [14 T.C. at 664-665.]

While we recognize that in *Estate of Miller* respondent argued that there had been a transfer of property that was subject to the estate tax, and in this case respondent argues that there has been a transfer of property that is subject to the gift tax, we do not believe that this difference is significant. To the contrary, this Court and others have long held that the estate and gift taxes are to be read in pari materia and construed together. *Merrill v. Fahs*, 324 U.S. 308, 311-313 (1945); *Estate of Sanford v. Commissioner*, 308 U.S. 39, 42, 44 (1939); *Carson v. Commissioner*, 71 T.C. 252, 260 (1978), affd. 641 F.2d 864 (10th Cir. 1981).

Respondent argues, however, that decedent's simple act of going to work for IBM on January 9, 1950, constituted an act of transfer by decedent for gift tax purposes. We disagree. None of the cases cited by respondent hold that, without more, the simple act of going to work for an employer that has an automatic, nonelective, company-wide survivors income benefit plan similar to the one at issue in this case constitutes a "transfer" of an interest in the benefit for either estate or gift tax purposes. Moreover, we doubt that it can be maintained seriously that decedent began his employment with IBM on January 9, 1950 (when he was 24, unmarried, and without dependents), for the purpose or with any intention of transferring property rights in the survivors income benefit. While we agree with respondent that a taxable event may occur without a volitional act by the donor, as in a case where an incomplete transfer of property becomes complete because of the occurrence of an event outside the donor's control, we do not believe that a taxable event can occur for gift tax purposes unless there is first and in fact an act of transfer by the donor; and there can be no act of transfer unless the act is voluntary and the transferor has some awareness that he is in fact making a transfer of property, that is, he must intend to do so. See *Harris v. Commissioner*, 340 U.S. 106, 109 (1950); *Welch v. Henry*, 305 U.S. 134, 147 (1938); *Estate of Hite v. Commissioner*, 49 T.C. 580, 594 (1968); *Seligmann v. Commissioner*, 9 T.C. 191, 195 (1947).[9] It is apparent to us that decedent never intended and never voluntarily acted to transfer any interest that he may have owned in the survivors income benefit. There being no act of transfer by decedent, there can be no transfer of property by gift.

Moreover, we question whether decedent ever owned a property interest in the survivors income benefit that he was capable of transferring during his lifetime.[10] He had no voice in selecting the beneficiaries of the survivors income benefit and no ability to affect or determine the benefits payable to them. The categories of beneficiaries, the determination whether a claimant is an eligible beneficiary, and the amounts payable to the beneficiaries all were controlled directly by the provisions of the plan and indirectly by IBM, and payments were made directly to the beneficiaries by IBM. Furthermore, the benefits were payable out of the general assets of IBM, not out of any fund in which decedent had a vested interest, and the benefits did not accrue until decedent's death. Most importantly, IBM had the power and the right to modify the plan and the survivors income benefit at any time and in its sole discretion. Under these circumstances, we have little difficulty in concluding that decedent never acquired fixed and enforceable property rights in the survivors income benefit that he was capable of transferring during his lifetime. In *Estate of Miller v. Commissioner*, *supra*, we reached the same conclusion, on similar facts, in the following language:

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[9] The fact that there can be no taxable gift unless there is a voluntary act of transfer does not mean that the donor also must have donative intent when he makes the transfer. Sec. 25.2511-1(g)(1), Gift Tax Regs.; *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945). Any completed transfer of a beneficial interest in property for less than an adequate and full consideration in money or money's worth, unless made in the ordinary course of business, will be subject to the gift tax. Sec. 25.2512-8, Gift Tax Regs.

[10] The parties stipulated that "Petitioner does not dispute Respondent's contention that Decedent's eligible survivors had a right to receive payment under the plan as long as the conditions set forth in the plan were satisfied." While we are uncertain what the parties intended by this stipulation, we note that to the extent it may be read as a stipulation of law, we are not bound by it. *Rollert Residuary Trust v. Commissioner*, 80 T.C. 619, 630 (1983), affd. 752 F.2d 1128 (6th Cir. 1985).

> The trustees were empowered at any time to change the rules and regulations or to substitute entirely new rules * * * . The pension trust could be terminated at any time by the bank and, although rule 29 provided that upon termination provision should be made for the continuance of all pensions then being paid to pensioners, there was no assurance that decedent's pension rights could have been enforced to their fullest extent against the pension trust unless there existed sufficient funds in the trust upon its cessation to discharge all of its obligations.
>
> Nor did the pension rights granted the wife * * * stand in any stronger position than those of her husband, for it is clear that whatever rights she possessed were subject to the same contingencies as those of the decedent * * * . Any pension granted to the wife would cease upon remarriage. * * * it is our considered opinion that decedent's pension rights and those of his wife under the pension trust never acquired the character of fixed and enforceable property rights which were susceptible to transfer by him * * *
>
> [14 T.C. at 664.]

Respondent argues, however, that in *Estate of Wolf v. Commissioner*, 29 T.C. 441 (1957), revd. on other grounds 264 F.2d 82 (3d Cir. 1959), we held in circumstances similar to those in this case, that decedent owned enforceable property rights in three trusts. The facts of *Estate of Wolf* are easily distinguishable from the facts of this case, however, for the same reason that in *Estate of Wolf* we istinguished *Estate of Miller v. Commissioner, supra*: in *state of Wolf* the employer had no unfettered right to odify or terminate the trusts, whereas here, as in *Estate f Miller*, the employer had the right to modify the plan at ny time and in its sole discretion. *Estate of Wolf v. ommissioner*, 29 T.C. at 447.

Respondent also attempts to distinguish *Estate of Miller* rom this case by arguing that payment of the survivors ncome benefit in this case was much more likely to occur han was payment of the pension benefit in *Estate of Miller*, because IBM's financial resources were much greater than he resources of the employer in *Estate of Miller*. In addition, respondent argues that the employer in *Estate of Miller* had the unfettered right to change the rules and regulations of the pension plan and even to terminate it, while in this case, IBM only had the right, in its discretion, to modify the plan. In our view, neither of these differences are significant.[11]

In our opinion, decedent never made a taxable gift of any interest in the survivors income benefit to his wife. It follows that the present value of the survivors income benefit is not an adjusted taxable gift within the meaning of section 2001.

Decision will be entered under Rule 155.

FRONTIER SAVINGS ASSOCIATION AND SUBSIDIARIES, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

FRONTIER SAVINGS AND LOAN ASSOCIATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 16209-81, 24559-83. Filed September 24, 1986.

In 1978 and 1979, petitioner, a stockholder of the Federal Home Loan Bank of Chicago (the Chicago Bank), received

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[11] **Respondent also argues, citing *Estate of Schelberg v. Commissioner*, 612 F.2d 25 (2d Cir. 1979), revg. 70 T.C. 690 (1978), that the survivors income benefit must be a taxable gift within the meaning of sec. 2503 because it is not taxable under sec. 2039. We of course express no view in this case as to whether the survivors income benefit is taxable under sec. 2039. However, even if the survivors income benefit is not taxable under sec. 2039, we fail to see how that could justify our reaching an improper result in this case.**

common stock dividends from the Chicago Bank. Also in 1978 and 1979, some of the stockholders requested that a portion of their shares of common stock in the Chicago Bank be redeemed. As it had in prior years, the Chicago Bank redeemed all shares of its common stock it was requested to redeem. *Held*: No stockholder had an election within the meaning of sec. 305(b)(1), I.R.C. 1954, to receive cash dividends in lieu of common stock dividends because the Chicago Bank retained discretion over the redemption of its common stock. Petitioner is not taxable on the value of the common stock dividends received in 1978 and 1979.

Robert A. Schnur, for the petitioner.
Mark D. Petersen, for the respondent.

SWIFT, *Judge*: In statutory notices of deficiency dated June 3, 1981, and August 12, 1983, respondent determined deficiencies in petitioner's Federal income tax liabilities as follows:

Years	*Deficiencies*
1977	$1,628.15
1978	19,376.14
1979	17,887.00

These cases have been consolidated for purposes of trial, briefing, and opinion.

Following concessions, the issue remaining for decision is whether stock dividends received by petitioner in 1978 and 1979 from the Federal Home Loan Bank of Chicago are taxable to petitioner under section 305(b)(1)[1]. The resolution of this issue will affect the taxability of stock dividends received by the other 496 stockholders of the Federal Home Loan Bank of Chicago which also received stock dividends in 1978 and 1979.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Petitioner Frontier Savings Association (Frontier Savings) is a mutual savings and loan association which was organized on February 19, 1919. It operates as a mutual savings association pursuant to Wisconsin law. The principal corporate office of Frontier Savings is located in Green Bay, Wisconsin. Frontier Savings and its subsidiaries timely filed consolidated Federal Corporation Income Tax Returns (Forms 1120) for each of the years 1978 and 1979.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

Frontier Savings has been a member and stockholder of the Federal Home Loan Bank of Chicago (the Chicago Bank) at all times since the organization of the Chicago Bank. The Chicago Bank is one of 11 district banks (12 prior to 1946) established pursuant to the Federal Home Loan Bank Act of 1932, 47 Stat. 725, 12 U.S.C. sec. 1421 et seq. The district banks were capitalized with stock subscriptions from member institutions and the U.S. Treasury. District banks operate under the supervision of the Federal Home Loan Bank Board, an administrative agency in the Executive Branch of the Federal Government. The Federal Home Loan Bank Board also is the chartering and regulatory authority for Federal savings and loan associations and Federal mutual savings banks.

The Federal Home Loan Bank system was designed primarily as a reserve credit facility for savings and loan associations and other home mortgage credit institutions. Savings and loan associations (such as Frontier Savings) and mutual savings banks that are members or stockholders in the district banks (hereinafter referred to as members or member banks) are required by Federal law to maintain a certain capital stock ownership in the respective district banks of which they are members. The stock ownership requirements are determined at the end of each calendar year and are calculated with reference to each member bank's net home mortgage loans outstanding and total borrowings of each member from the district bank.

Each member bank generally must maintain a capital stock ownership interest in the district bank in an amount equal to at least 1 percent of the total outstanding balance of its home mortgage loans[2] and at least equal to one-twelfth[3] of total outstanding borrowings of the member bank from the district bank, as of December 31 of each year. Each share of stock in the district banks is valued by statute at its $100 par value. See 12 U.S.C. sec. 1426(b) an (c) (1978).

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[2] Each bank that became a member before Sept. 8, 1961, is required to maintain a stock ownership interest of 2 percent of its total outstanding balance of home mortgage loans.

[3] This requirement was changed to one-twentieth in 1979. Act of Dec. 21, 1979, sec. 327, Pub. L. 96-153, 93 Stat. 1121.

Based upon the above yearend calculations, membe banks that are required to purchase additional stock o district banks must do so by January 31 of the followin year at the par value of $100 per share. Member banks tha own stock in district banks in excess of the require number of shares (excess shares) may request that exces shares be redeemed by the district banks.

The policy of the Chicago Bank with respect to th redemption of excess shares is reflected in the minutes of June 18, 1979, meeting of the Chicago Bank's board o directors, as follows:

> BE IT RESOLVED, that the President of the Bank or any office designated by him may from time to time increase or decrease th amount of stock of any member in accordance with Section 6 of th Federal Home Loan Bank Act [i.e., 12 U.S.C. §1426(c)] and th Regulations for the Federal Home Loan Bank System; provided, howeve that in exercising the Bank's discretion whether or not to grant a application by a member to decrease its stock, the President or hi designee shall be guided by all applicable statutory and regulator provisions, all policies and standards adopted from time to time by th Board, including, but not limited to, the Bank's credit standard contained in the "Policies Governing Extension of Credit" as adopted b this Board and all relevant facts and circumstances.

As of December 31, 1977, Frontier Savings owned 6,72 shares of stock in the Chicago Bank, all of which it ha purchased over many years from the Chicago Bank at $10 per share. On that day, the principal amount of Frontie Savings' outstanding mortgage loans and borrowings fron the Chicago Bank was such that, prior to January 31, 197 Frontier Savings was required to increase its stock interes in the Chicago Bank to 9,066 shares. Accordingly, durin January of 1978, Frontier Savings purchased 2,345 add tional shares of the common stock of the Chicago Bank fo $234,500. Frontier Savings neither purchased nor sold an additional shares of common stock in the Chicago Bank i 1978, so that as of December 28, 1978, Frontier Saving owned 9,066 shares of the common stock of the Chicag Bank.

As stockholders in district banks, member banks ar entitled to receive dividends that are declared by distric banks. Prior to December 29, 1978, dividends were paid by the Chicago Bank to its member banks in the form of cash. On December 29, 1978, dividends were paid by the Chicago Bank to its member banks in the form of additional shares of common stock. On December 31, 1979, dividends were paid by the Chicago Bank to its member banks half in stock and half in cash.

December 29, 1978, Stock Dividend

At a meeting held on November 20, 1978, the board of directors of the Chicago Bank adopted a resolution to pay a 6.58-percent dividend to its stockholders of record as of December 31, 1978. Subject to the approval of the Federal Home Loan Bank Board, the resolution stated that the dividend would be paid in the form of shares of stock in the Chicago Bank. On December 22, 1978, the Director of the Office of District Banks, Federal Home Loan Bank Board, wrote a letter to the President of the Chicago Bank approving the stock dividend.

On December 22, 1978, the Chicago Bank mailed a bulletin to its member banks, informing them that a 6.58-percent stock dividend would be paid, with fractional shares to be paid in cash. The explanation made in the bulletin for paying a stock dividend, rather than a cash dividend, was as follows:

> (1) Providing a stock rather than a cash dividend may enable your association to defer the payment of income taxes on the value of the stock dividend. You may wish to consult your tax adviser for the proper handling of a stock dividend.
>
> (2) A stock dividend can be applied toward satisfying the stock investment requirement for members that experienced a growth in assets during 1978 or that will be required to purchase additional stock due to increased borrowings from the Bank.

The bulletin also explained that most member banks would be required to increase their stock holdings in the Chicago Bank due to that year's general increase in outstanding home mortgage loans.

On December 29, 1978,[4] the Chicago Bank distributed the 1978 stock dividend by (1) crediting the appropriate number of whole shares of stock to the stock account of each member bank, (2) crediting an appropriate amount of cash with respect to fractional shares to the demand account of each member bank, and (3) issuing a new stock certificate to each member bank. Each new stock certificate reflected the total number of shares of stock held by each member bank before the stock dividend, the number of shares of stock distributed pursuant to the dividend, and the total number of shares of stock owned by each member bank after distribution of the dividend. The Chicago Bank maintained records of the stock ownership accounts of its member banks.

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[4] There is no explanation in the record for the discrepancy between the board of director's resolution declaring that the dividend would be payable to stockholders of record as of Dec. 31, 1978, and the fact that the stock dividend actually was paid on Dec. 29, 1978.

On December 29, 1978, a total of 234,620 shares of common stock was distributed by the Chicago Bank as a stock dividend to its 497 member banks. On December 29, 1978, Frontier Savings received 588 shares of common stock in the Chicago Bank (and cash representing fractional shares in the amount of $51.07) as its share of the 1978 stock dividend.

Common Stock Purchases and Redemptions Relating to December 31, 1978, Stock Ownership Requirements

Enclosed with the December 22, 1978, bulletin mailed by the Chicago Bank to its member banks describing the 1978 stock dividend was a form entitled "Calculation of Bank Stock Requirement as of December 31, 1978." Using that form, each member bank could calculate the number of shares of stock it was required, under 12 U.S.C. sec. 1426(c) (1978), to own in the Chicago Bank as of December 31, 1978. If a member bank was required to purchase additional shares of stock, it could submit the form (reflecting the number of shares to be purchased) along with a check in payment therefor to the Chicago Bank. If the member bank held more shares than it legally was required to own, it could use the form to request the redemption of any excess shares. Although the Chicago Bank had no legal obligation to redeem excess shares, in prior years it routinely had done so.

On January 16, 1979, Frontier Savings completed the form calculating the number of shares of common stock in the Chicago Bank it was required to own based on its

December 31, 1978, outstanding balance for home mortgage loans. That calculation indicated that Frontier Savings was required to purchase 678 additional shares of common stock in the Chicago Bank (after taking into account the shares received as part of the common stock dividend on December 29, 1978). Frontier Savings, therefore, sent a check in the amount of $67,800 to the Chicago Bank and 678 shares were credited to its stock account at the Chicago Bank. A new stock certificate was issued reflecting the ownership by Frontier Savings of a total of 10,332 shares of common stock in the Chicago Bank. During 1979, none of the shares of common stock in the Chicago Bank owned by Frontier Savings were redeemed or otherwise transferred.

Exclusive of the December 29, 1978, stock dividend received, on December 31, 1978, 195 of the 497 member banks owned sufficient shares of common stock in the Chicago Bank to meet their stock ownership requirements, and 302 member banks did not own sufficient shares to meet their stock ownership requirements. After receipt of the 1978 stock dividend, 69 member banks requested that the Chicago Bank redeem all or some of their excess shares. All such redemption requests were agreed to by the Chicago Bank and the following number of shares of common stock were redeemed by the Chicago Bank from its member banks in the months indicated:

Time period	*Shares redeemed*
December 1978	1,240
January 1979	62,575
February 1979	8,249
Remainder of 1979	22,256

During December of 1978 and 1979, 45 member banks redeemed a number of shares of stock in the Chicago Bank that was equal to or that exceeded the number of shares they received as their portion of the 1978 stock dividend.

1979 Cash and Stock Dividends

At a meeting held on November 19, 1979, the board of directors of the Chicago Bank adopted a resolution, subject to the approval of the Federal Home Loan Bank Board, to pay a 10-percent dividend to its stockholders of record as of December 31, 1979, half of which would be paid in cash and half of which would be paid in the form of common stock of the Chicago Bank. On December 13, 1979, the Federal Home Loan Bank Board approved payment by the Chicago Bank of the proposed cash and stock dividends. On December 21, 1979, the Chicago Bank mailed a bulletin to its member banks, informing them that the 10-percent dividend would be paid to the stockholders on December 31, 1979.

On December 31, 1979, the Chicago Bank distributed the 1979 dividends by (1) adding the appropriate number of whole shares of stock to the stock account of each member, and (2) adding to the demand account of each member the amount representing the cash portion of the dividend as well as the amount of cash representing fractional shares of stock distributed as part of the dividend. A total of 209,197 shares of stock was distributed by the Chicago Bank as a stock dividend to its 497 member banks on December 31, 1979. Frontier Savings received 514 shares of Chicago Bank common stock as its portion of the 1979 stock dividend and $51,567.87 in cash as its portion of the cash dividend.

Common Stock Purchases, Sales, and Redemptions Relating to December 31, 1979, Stock Ownership Requirements

The December 21, 1979, bulletin mailed to member banks concerning the 1979 dividends explained that "to help preserve the non-taxable characteristics of the stock dividend" a new procedure was being adopted for the purchase and disposition of excess shares of stock in the Chicago Bank. Instead of having member banks purchase additional shares of stock from the Chicago Bank and instead of having the Chicago Bank redeem excess shares from member banks, the new procedure called for member banks who had excess shares they wished to dispose of to sell such excess shares to other member banks who wished to buy additional shares.

Enclosed with the December 21, 1979, bulletin was a form entitled "Calculation of Bank Stock Requirement" as of December 31, 1979, and a separate form that could be used by the member banks to notify the Illinois and Wisconsin

League Offices[5] of their desire to sell excess shares of stock in the Chicago Bank to other member banks. Each member bank was required to notify the Chicago Bank of any purchases of shares of stock in the Chicago Bank so the changes in ownership of the stock could be reflected on its records.

Frontier Savings completed its form for the "Calculation of Bank Stock Requirement" on January 29, 1980. Thereon, it was indicated that, based on its December 31, 1979, loan balance figures, Frontier Savings was required to purchase 520 additional shares of common stock in the Chicago Bank. Frontier Savings, therefore, mailed a $52,000 check to the Chicago Bank, and the Chicago Bank credited Frontier Savings with 520 shares of stock, increasing the total number of shares in petitioner's stock account to 11,366.

Exclusive of the December 31, 1979, stock dividends, 282 of the Chicago Bank's 497 member banks owned sufficient shares of stock in the Chicago Bank to meet their stock ownership requirements on December 31, 1979, and 215 member banks did not own sufficient shares. After receipt of their 1979 stock dividends from the Chicago Bank, 31 member banks sold some of their stock to other member banks, and 10 bought additional stock from member banks. A total of 85,859 shares of stock in the Chicago Bank was exchanged between member banks during December of 1979 and January of 1980.

Sales of excess shares between member banks occurred only in January of 1980. Excess shares that member banks wished to dispose of after January of 1980 were redeemed by the Chicago Bank. Between February 1, 1980, and December 31, 1980, 64 member banks requested the Chicago Bank to redeem their excess shares. Sixty member banks redeemed a number of shares that was equal to or that exceeded the number of shares they received as their portion of the 1979 stock dividend. The Chicago Bank honored all redemption requests received during that period of time and the following number of shares were redeemed in the months indicated:

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[5] Although not explained in the record, apparently the Illinois and Wisconsin League offices were trade associations of member banks which agreed to act as intermediaries to effect the sales of stock between member banks in January of 1980.

Time period	*Shares redeemed*
February 1980	177,254
March 1980	61,837
Remainder of 1980	43,199

None of the shares of stock in the Chicago Bank received by Frontier Savings with respect to the 1978 and 1979 stock dividends were redeemed by the Chicago Bank or otherwise disposed of by Frontier Savings prior to 1982. In January of 1982, the Chicago Bank, at the request of Frontier Savings, redeemed 3,584 shares of its stock owned by Frontier Savings.

OPINION

The receipt of common stock dividends generally is not taxable to stockholders. Sec. 305(a). Where, however, dividends from a corporation are payable, at the election of the stockholders, in stock or property (such as cash), the receipt of dividends will be taxable to the stockholders under the provisions of section 301. Sec. 305(b)(1).[6] In that circumstance, the receipt of stock dividends will be taxable under sections 305(b)(1) and 301 regardless of whether the stockholders exercise their election to receive the dividends in cash or other property. Sec. 1.305-2(a), Income Tax Regs.[7]

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[6] Sec. 305(a) and (b)(1) provide as follows:

(a) GENERAL RULE.—Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

(b) EXCEPTIONS.—Subsection (a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which section 301 applies—

(1) DISTRIBUTIONS IN LIEU OF MONEY.—If the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either—

(A) in its stock, or,

(B) in property.

[7] Sec. 1.305-2(a), Income Tax Regs., provides in part as follows:

Distributions in lieu of money.

(a) *In general.*—Under section 305(b)(1), if any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in the other;

Respondent argues that by redeeming all of the common stock it was requested to redeem from its member banks in 1979 and 1980 (and apparently doing so in years before 1979), the Chicago Bank established such a policy and practice of redeeming excess stock upon request of the member banks that the member banks should be regarded as having had an "election" to receive the 1978 and 1979 stock dividends in cash. Respondent therefore argues that the stock dividends in question do not qualify for exemption from taxability under section 305(a) and should be taxable to the member banks under sections 305(b)(1) and 301. For the reasons explained below, we disagree.

The Federal statute under which the Federal Home Loan Bank Board and the district banks regulate certain activities of member banks addresses the authority of district banks to redeem common stock from its member banks and explicitly describes that authority as discretionary with each district bank. Section 1426(c) of the Federal Home Loan Bank Act as amended in 1961 provides, in relevant part, as follows:

> If the bank finds that the investment of any member in stock is greater than that required under this subsection it *may, unless prohibited by said Board* [i.e., the Federal Home Loan Bank Board] *or by the provisions of paragraph (2) of this subsection, in its discretion* and upon application of such member retire the stock of such member in excess of the amount so required. * * * [12 U.S.C. sec. 1426(c) (1961), as amended by Act of Sept. 8, 1961, subsec. (c), Pub. L. 87-210, 75 Stat. 482. Emphasis supplied.]

A comparison of the language quoted above (reflecting the 1961 amendment to section 1426(c)) with the language of the predecessor statute to section 1426(c) (as originally enacted in 1932) is particularly significant. As originally enacted, section 1426(c) of the Federal Home Loan Bank Act of 1932, *supra*, provided as follows:

> If the board finds that the investment of any member in stock is greater than that required under this section, upon application of such member, *the bank shall pay such member for each share of stock in excess of the amount so required* an amount equal to the value of such stock * * *

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(4) Whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

(5) Whether all or part of the shareholders have the election.

[Federal Home Loan Bank Act of 1932, *supra*, sec. 1426(c). Emphasis supplied.]

The language quoted immediately above suggests that member banks may have had the right to require district banks to redeem excess shares before the 1961 amendment to section 1426(c) (12 U.S.C.). That is suggested by use in the statutory language of the mandatory "shall." Nothing, however, in the Federal Home Loan Bank Act, in its present form, suggests that since 1961 anyone other than the district banks and the Federal Home Loan Bank Board have the authority to determine whether excess shares will be redeemed.

The policy of the Chicago Bank with respect to the redemption of excess shares, as reflected in the minutes of the June 18, 1979, meeting of its board of directors, is entirely consistent with the above statutory provisions. Also, the bulletins mailed in December of 1978 and 1979 by the Chicago Bank to its members do not communicate any contrary policy to member banks. Those bulletins acknowledged that although the issuance of stock dividends was attributable, in part, to a perceived tax planning opportunity, the distributions of stock dividends also were attributable to the recognized need for a number of member banks to acquire additional shares of common stock in the Chicago Bank. With respect to the holding of excess shares, the bulletin dated December 22, 1978, simply suggested that member banks "may want to retire" such stock. The bulletin dated December 21, 1979, stated that it was "hoped that the majority of those holding excess stock will choose to hold the stock to meet future needs and for investment purposes," but that if they chose to sell excess shares to another member bank the league offices will "make every effort to bring you in contact with a member * * * willing to purchase" the excess shares. Neither bulletin suggested that the Chicago Bank necessarily would grant any or all redemption requests.

Congress vested in the district banks and in the Federal Home Loan Bank Board discretionary authority to redeem excess shares of common stock held by member banks. Our careful examination of the record herein satisfies us that the manner in which stock dividends were paid and redeemed in

1978 and 1979 by the Chicago Bank was consistent with that grant of discretionary authority and did not vest in the member banks the unilateral right to elect or to require the Chicago Bank to redeem excess shares upon request.

Respondent concedes that the Chicago Bank did not completely abdicate its discretionary authority to redeem its stock but respondent argues that that authority was exercised so consistently in favor of redemption that member banks, as a practical matter, had the option or election to have excess shares redeemed at any time. Respondent contends that the option arose "from the circumstances of the distribution," citing section 1.305-2(a)(4), Income Tax Regs. As indicated, we have carefully examined the circumstances of the stock dividends in question and conclude that the member banks, including Frontier Savings, did not have the option or election to have the Chicago Bank redeem excess shares of common stock in the Chicago Bank.

In addition to the factors explained above, we think it significant that the stock dividends of the Chicago Bank were declared and distributed in late December of 1978 and 1979. Member banks, however, normally would not be able to determine until early in the following year (after actual distribution of the stock dividends) whether they would be able even to request a redemption of some of their common stock in the Chicago Bank. In other words, on the day of distribution of the stock dividends, member banks could not know (other than through estimates and projections) whether they would be required to retain the stock dividends they received as part of their required investments in the district bank or whether the stock dividends would qualify as excess shares, in which case redemption thereof, if requested, might occur depending on the decision of the Chicago Bank.[8]

The parties have cited only one case that involves facts at all similar to those involved herein. In *Rinker v. United States*, 297 F. Supp. 370, 371 (S.D. Fla. 1968), the board of directors of a corporation adopted a resolution with respect to stock dividends and the ability to redeem the stock dividends, as follows:

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[8] In one case a member bank, apparently on Dec. 29, 1978, was able to determine that its stock dividend would constitute excess shares and was able to request a redemption on the same day the stock distribution occurred.

> RESOLVED, that a stock dividend of 5% be paid to holders of record on March 31, 1960, on or before July 15, 1960, and that said dividends *may* be cashed at the request of the stockholders at a value per share yet to be determined. [Emphasis added.]

Among other factors, the District Court emphasized the use of the word "may" in the corporate resolution and held that the stockholders did not have an election to receive cash, in lieu of the stock dividends.

We recognize that the issuance by the Chicago Bank in 1978 and 1979 of stock dividends instead of or in addition to cash dividends was motivated in part by tax considerations. We cannot conclude, however, on the facts before us that the stock dividends were a mere subterfuge for cash distributions (see *Rinker v. United States*, *supra* at 372), or that the Chicago Bank had relinquished its discretionary authority to decline to grant stock redemption requests.

Respondent refers to Rev. Rul. 76-258. 1976-2 C.B. 95. Revenue Rulings are, of course, not binding on this Court. *Estate of Lang v. Commissioner*, 64 T.C. 404, 406-407 (1975), affd. 613 F.2d 770 (9th Cir. 1980). Respondent's litigating position herein is reflected in Rev. Rul. 83-68, 1983-1 C.B. 75. For the reasons explained above and under the facts of this case, we reject the conclusion reached therein that a history or practice of redemptions by the Chicago Bank makes the stock dividends received by petitioner herein taxable under sections 305(b)(1) and 301.

In light of our resolution of this issue, it is not necessary to address certain alternative arguments made by the parties.

Decisions will be entered under Rule 155.

Reviewed by the Court.

STERRETT, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, JACOBS, and PARR agree with the majority opinion.

SIMPSON, *J.*, dissents.

GERBER, WRIGHT, and WILLIAMS, *JJ.*, did not participate in the consideration of this case.

HAMBLEN, *J.*, concurring: I concur in the conclusion of the majority based upon the limited factual circumstances involved. If a discretionary act of the board of directors of a shareholder corporation to redeem stock dividends becomes a routine matter, it might, in my opinion, develop into an "option" that arises after the distribution or a distribution pursuant to a "plan." See secs. 1.305-2(a) and 1.305-3(b), Income Tax Regs. In such a situation, it seems the redemptions might be periodic rather than isolated. The broad rules of section 305 could invoke different considerations under other circumstances.

STERRETT, COHEN, and JACOBS, *JJ.*, agree with this concurring opinion.

GERLING INTERNATIONAL INSURANCE COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26765-83. Filed September 24, 1986.

In implementation of its prior opinion, see 86 T.C. 468 (1986), the Court determined that petitioner should be precluded from introducing into evidence the books and records of a deemed related Swiss corporation or any information derived therefrom. *Held*, no change should be made in the two orders of the Court, dated Mar. 12, 1986, and Apr. 9, 1986, and accordingly petitioner's motion for summary judgment is denied. *Held, further*, respondent's motion for summary judgment is granted.

Lawrence Gerzog, for the petitioner.
David Brodsky, for the respondent.

OPINION

TANNENWALD, *Judge*: This case is again before us on cross motions for summary judgment. The parties agree (and we concur) that, in the present posture of the case, there are no genuine issues of material fact involved; consequently, we may dispose of the case by decision as a matter of law. Rule 121, Tax Court Rules of Practice and Procedure.

The factual background, which provides the foundation for the motions herein, is largely set forth in our prior opinion, 86 T.C. 468 (1986), and will not be repeated herein. Rather, we will set forth what has occurred since the memorandum sur order, which subsequently became the aforementioned published opinion, was issued on March 12, 1986.

Simultaneously with the issuance of the memorandum sur order, an order was entered. A copy of that order is set forth as Exhibit A to this opinion. Thereafter, the parties attempted to arrive at a mutually acceptable procedure pursuant to which respondent would be afforded the opportunity to examine the books and records of Universale Reinsurance Co., Ltd. (Universale). Their attempt failed for the reasons hereinafter set forth. As a consequence, the Court issued a further order, dated April 9, 1986, copy of which is set forth as Exhibit B to this opinion.

Upon the basis of the two above-mentioned orders of the Court and other material of record herein, respondent moved for summary judgment contending that, because of the preclusion of evidence provision of the Court's April 9, 1986, order, petitioner would, as a matter of law, be unable to meet its burden of proof and that consequently a decision should be entered for respondent.[1]

Petitioner countered respondent's motion for summary judgment with a cross motion for summary judgment. In support of its cross motion, petitioner argues that: (1) Respondent has ignored the economic reality of its relationship with Universale; (2) while the Court (incorrectly according to petitioner) rejected that argument in its prior opinion, the argument nevertheless supports the contention that respondent has acted arbitrarily and unreasonably in issuing the deficiency notice herein, particularly in light of respondent's prior acceptance of petitioner's method of reporting, for U.S. tax purposes, only the net income or loss revealed by the annual statements furnished it by Universale; (3) petitioner has made every effort to permit respondent to audit the books and records of Universale and the condition, insisted upon by respondent, that the audit first be approved by the Swiss Federal Government (see p. 682 *infra*), is unreasonable and was properly rejected by Universale and consequently by petitioner.

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[1] Such preclusion would prevent petitioner from satisfying its burden of proof, not only as to the amount of the allowable deductions for losses and expenses, but also the adjustments by respondent as to the proper year for reporting of petitioner's share of the premiums, losses and expenses, of Universale.

Petitioner's first two arguments have essentially been disposed of by our prior opinion. See 86 T.C. at 473-474. Petitioner's "economic reality" argument ignores the nature of the relationship between petitioner and Universale, namely agent (Universale) and principal (petitioner). See *Colonial Surety Co. v. United States*, 147 Ct. Cl. 643, 178 F. Supp. 600, 602 (1959). If, in fact, Universale has ascribed to petitioner more than its proper share of losses and expenses, petitioner has not received the share of the net income due it. It is well established that income received by an agent is taxable to a principal at the time of receipt by the agent, rather than at the time of payment by the agent to the principal. *Maryland Casualty Co. v. United States*, 251 U.S. 342, 347 (1920); *Alsop v. Commissioner*, 290 F.2d 726, 728 (2d Cir. 1961), affg. 34 T.C. 606 (1960). See also *McGahen v. Commissioner*, 76 T.C. 468, 478 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983).

Petitioner seeks to avoid the principal-agent characterization by contending that its arrangement with Universale was one of indemnity, as distinguished from assumption, reinsurance. See secs. 1.809-4(a)(1)(iii) and 1.809-5(a)(7)(ii), Income Tax Regs. Aside from the fact that we have serious doubts as to the validity of petitioner's position in light of the terms of the treaty between petitioner and Universale, and particularly article 4 thereof (see 86 T.C. at 469-470), we think any such distinction is irrelevant under the facts and circumstances herein. Cf. *International Life Insurance Co. v. Commissioner*, 51 T.C. 765, 772 (1969), affd. per curiam 427 F.2d 137 (6th Cir. 1970). To permit any such distinction, in the context of the instant case, would preclude respondent from questioning the underpinnings of any indemnity arrangement in order to determine the proper tax consequences flowing therefrom and to obtain the information necessary to make such questioning effective.

We are unable to perceive why, having refused to accept petitioner's "economic reality" argument as a matter of substantive law, we should nevertheless apply that argument in order to hold that respondent's determinations in the notice of deficiency were arbitrary. Nor are we persuaded that we should do so because respondent did not question petitioner's method of reporting its transactions with Universale over a period of 18 years and, in fact, accepted such method after examining petitioner's returns for the taxable years 1959, 1960, and 1961. It is well established that a taxpayer is not entitled to continue the treatment of an item of income or deduction simply because respondent either has not objected in the past or has approved like treatment of the item in an earlier year. *Coors v. Commissioner*, 60 T.C. 368, 406 (1973), affd. 519 F.2d 1280 (10th Cir. 1975); *Union Equity Cooperative Exchange v. Commissioner*, 58 T.C. 397, 408 (1972), affd. 481 F.2d 812 (10th Cir. 1973).

We now turn to the third prong of petitioner's argument. See pp. 680-681, *supra*. Both prior and subsequent to the Court's order of March 12, 1986 (Exhibit A), discussions took place between petitioner (who consulted Universale) and respondent. As a result of those discussions, Universale, through petitioner, offered to have an American C.P.A. firm, with an office in Switzerland, selected and paid by respondent, audit the relevant books and records of Universale at Universale's office in Zurich, Switzerland, and transmit the results of that audit to respondent. Respondent, however, was concerned about the effect of article 271 of the Swiss Penal Code,[2] and insisted that the Swiss Federal Government be informed of, and approve, the audit. Universale refused to accede to that condition because it did not want "to engender Swiss governmental intrusion into a matter in which neither Universale nor the Swiss government are parties" and asked that the auditors "do the audit n an invitation-type basis." See Petitioner's Memorandum n Support of its Cross-Motion for Summary Judgment, pp. 9-10. As a consequence of that refusal, respondent eturned to his original position that Universale's books and records be produced in the United States for examination by respondent's agents, a situation described by petitioner as an "impractical and inequitable demand." *Supra* at p. 10.

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[2] Art. 271 of the Swiss Penal Code provides in translation as follows:

"Anyone who, without authorization, takes in Switzerland for a foreign state any action which is within the powers of the public authorities,

"Anyone who takes such actions for a foreign party or for any other foreign organization,
"Anyone who facilitates such actions,

"Shall be punished with imprisonment, in serious cases with penitentiary confinement."

Petitioner vigorously asserts that respondent's insistence on approval of the audit in Switzerland by the Swiss Federal Government is unreasonable. We disagree.

In the first place, article 271 of the Swiss Penal Law clearly prohibits an examination in Switzerland by respondent's agents. See note 2 *supra*; *United States v. Vetco, Inc.*, 691 F.2d 1281, 1290 (9th Cir. 1981). Clearly, we should not countenance action by *agents of the United States Government* which would cause a violation of the laws of a nation with whom we have friendly relations. See *Application of Chase Manhattan Bank*, 297 F.2d 611, 613 (2d Cir. 1962).[3] Nothing in article 271 suggests that an "invitation-type" audit, i.e., an audit with Universale's consent, would remove respondent's agents from the sanctions of article 271. In the second place, even if the use of an "invitation-type" audit might arguably avoid the need for the approval of the Swiss Federal Government, we do not think it is within our province to second-guess respondent on this issue. It is common knowledge that the efforts of the United States to obtain the cooperation of the Swiss Federal Government in facilitating the enforcement of our tax laws have involved delicate and sometimes difficult negotiations. "[T]he courts must take care not to impinge upon the prerogatives and responsibilities of the political branches of the government in the extremely sensitive and delicate area of foreign affairs." See *United States v. First National City Bank*, 396 F.2d 897, 901 (2d Cir. 1968). See also *United States v. Davis*, 767 F.2d 1025, 1035 (2d Cir. 1985). The fact that the alternative of producing the books and records of Universale in the United States may be expensive or cumbersome and therefore impose some hardship on petitioner and Universale does not make respondent's position unreasonable. See *United States v. Vetco, Inc.*, *supra* at 1289, 1291. We hold that respondent's condition that the approval of the audit by the Swiss Federal Government should be obtained is not unreasonable.

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[3] Petitioner's suggestion that somehow the American C.P.A. firm conducting the audit would not be an agent of respondent for the purposes of art. 271 of the Swiss Penal Law is disingenuous to say the least. Cf. *Application of Chase Manhattan Bank*, 297 F.2d 611, 613 (2d Cir. 1962).

At one point in these proceedings, petitioner suggested that disclosure of its books and records by Universale to respondent's agents might violate article 273 of the Swiss Penal Law dealing with disclosure by any person of a "business secret * * * to a foreign authority."[4] Petitioner has not, however, pursued this line of argument and, in any event, we are of the view that article 273 should not relieve petitioner of its obligation to cause the books and records to be produced. *United States v. Vetco, Inc.*, *supra* at 1289-1291; *Fontaine v. Securities and Exchange Commission*, 259 F. Supp. 880, 887-889 (D. Puerto Rico 1966); cf. *United States v. First National City Bank*, *supra*. See also *United States v. Vetco, Inc.*, *supra* at 1288 n. 8. Similarly, petitioner's passing reference to the possible use of letters rogatory by respondent (a line of argument also not pursued) is without merit. See United States v. Vetco, Inc., *supra* at 1290.

In sum, we see no reason to modify our prior orders of March 12, 1986, and April 9, 1986 (Exhibits A and B). Accordingly, petitioner's cross-motion for summary judgment is denied.[5]

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[4] Art. 273 of the Swiss Penal Code in translation provides as follows:

"Whoever explores a manufacturing or business secret in order to make it accessible to a foreign authority or a foreign organization or a foreign private business enterprise or their agents,

"Whoever makes a manufacturing or business secret accessible to a foreign authority or a foreign organization or a foreign private business enterprise or their agents,

"Shall be punished with imprisonment, in serious cases with penitentiary confinement. This deprivation of liberty can be combined with a fine."

See also *United States v. Vetco, Inc.*, 691 F.2d 1281, 1287 (9th Cir. 1981); *Fontaine v. Securities and Exchange Commission*, 259 F. Supp. 880, 888 n. 7 (D. Puerto Rico 1966).

[5] We note in passing that, even if we were to accept petitioner's argument, we would not equate arbitrariness on the part of respondent with making his notice of deficiency invalid. At most, we would have shifted the burden of going forward with the evidence to respondent. Respondent's disallowance of the deductions for losses and expenses does not fall within the exception to the rule which has been fashioned by the Second Circuit Court of Appeals (to which an appeal in this case will lie) and which expands the character of the relief available where the circumstances, i.e., absence of linkage of the taxpayer with an income-producing activity, dictate that a notice of deficiency should be held to be arbitrary. See *Llorente v.*

We now turn to respondent's motion for summary judgment. There appears to be no possibility, given the preclusion of evidence provision of our order of April 9, 1986, that petitioner can carry its burden of proof. We are therefore satisfied that respondent's motion should be granted. We observe that, although this action appears to amount to the sanction of dismissal of the proceeding—a sanction which the Supreme Court admonished should be applied with extreme care in *Societe Internationale, Etc. v. Rogers*, 357 U.S. 197 (1958)—the fact of the matter is that we take this action only after having given petitioner (and Universale) an opportunity to produce material which we considered essential to enable respondent adequately to defend against the evidence which petitioner proposed to present in order to sustain its position that respondent's notice of deficiency was erroneous. Cf. *Fontaine v. Securities and Exchange Commission, supra* at 885. Our reasoning with respect to the appropriateness of using the authority of the Court to make this material available to respondent and the considerations which lead us to believe that we have stayed within the parameters outlined by the Supreme Court are set forth in our prior opinion, and we see no purpose to be served by repeating them here. See also *United States v. Vetco, Inc., supra* at 1287-1288. Given the deemed relationship between petitioner, Universale, and Robert Gerling described in that opinion, we are satisfied that we have appropriately balanced the interests of the parties, Universale and the Swiss Federal Government herein (see *United States v. Vetco, Inc., supra* at 1288-1291; *United States v. Chase Manhattan Bank, N.A.*, 584 F. Supp. 1080, 1083-1087 and 590 F. Supp. 1160 (S.D. N.Y. 1984); see also *Gerling International Insurance Co. v. Commissioner, supra* at 476.[6]) and that our disposition of this proceeding in respondent's favor is merited even though it will result in a substantial liability on the part of petitioner—a liability much greater than that

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Commissioner, 649 F.2d 152 (2d Cir. 1981), affg. in part, revg. in part, and remanding 74 T.C. 260 (1980); *Tokarski v. Commissioner*, 87 T.C. 74 (1986); *Dellacroce v. Commissioner*, 83 T.C. 269, 287 (1984). See also *Gerling International Insurance Co. v. Commissioner*, 86 T.C. 468, 476 n. 5 (1986).

[6] For a comprehensive discussion of the relationship between discovery and foreign law compulsion, see American Law Institute Restatement of the Law, Foreign Relations of the United States (Revised) Tentative Draft No. 7, adopted in May 1986.

which may well have existed if Universale's books and records had been made available.

An appropriate order will be entered.

EXHIBIT A

UNITED STATES TAX COURT
Washington, D.C. 20217

GERLING INTERNATIONAL)
INSURANCE CO.)
)
Petitioner,)
)
V.) Docket No. 26765-83
)
)
COMMISSIONER OF INTERNAL REVENUE,)
)
Respondent.)

ORDER

Respondent having, on February 11, 1985 filed a Motion for Order Compelling Petitioner to Answer Respondent's Interrogatories or to Impose Sanctions; a hearing having been held thereon on April 22, 1985; the Court having, on April 29, 1985, issued an order directing petitioner to respond to certain of said interrogatories and having indicated in said order the likely consequence of petitioner failing satisfactorily to do so; petitioner having submitted to respondent responses to said interrogatories; further hearing having been held on respondent's motion on November 20, 1985; respondent having, on December 30, 1985, filed a Motion for an Order Compelling Petitioner to Comply with Respondent's Response for Production of Documents or to Impose Sanctions; a hearing on both of respondent's said motions having been held on January 14, 1986, and the Court having, in a telephone conference held on March 3, 1986 informed the parties of its intention to issue this order and set the above-docketed case for trial on April 16, 1986, pursuant to the accompanying memorandum sur order, it is

ORDERED: that such part of respondent's motion as requests sanctions for petitioner's failure to respond satisfactorily to interrogatories Nos. 45 and 81 is granted in that the following items are conclusively presumed to be true solely for the purposes of the above docketed case:

(1) At least from January 1, 1976 to the present and continuing, Robert Gerling owned substantially all the stock of Universale Reinsurance Company, Ltd, Zurich, Switzerland (hereinafter Universale);

(2) At least from January 1, 1976 to the present and continuing, by virtue of his position as Chairman of the Board of Directors and the owner of substantially all the stock of Universale, Robert Gerling was, and is, in a position to help make arrangements so as to enable petitioner to comply with respondent's request that there be made available to respondent any and all books and records which reflect the premiums, losses, expenses and other items subject to the reinsurance treaty between petitioner and Universale.

(3) Petitioner shall, on or before April 2, 1986, cause the aforesaid books and records of Universale to be produced or made available to respondent at the office of respondent's counsel or at such other location as may be mutually satisfactory. It is further

ORDERED: that nothing in this order shall be construed as discouraging the continued efforts by the parties to make arrangements for such production or availability, including the geographical location thereof, and the Court is prepared to render all appropriate assistance to the furtherance of such efforts. If the Court is informed that such arrangements have been made, the Court will take appropriate action to extend the aforementioned April 2, 1986 date and/or to make such other modifications of the within order as it deems advisable.

This order constitutes official notice to the parties of the contents thereof.

(S) Theodore Tannewald, Jr.
THEODORE TANNEWALD, JR.
Judge

Dated: Washington, D.C.
March 12, 1986

EXHIBIT B

UNITED STATES TAX COURT
Washington, D.C. 20217

GERLING INTERNATIONAL)
INSURANCE CO.)
)
Petitioner,)
)
V.) Docket No. 26765-83
)
)
COMMISSIONER OF INTERNAL REVENUE,)
)
Respondent.)

ORDER

The Court having issued an order dated March 12, 1986, directing petitioner, on or before April 2, 1986, to cause certain books and records of Universale Reinsurance Company, Ltd. (Universale) to be produced or made available to respondent and the Court having been informed in a telephone conference with Counsel for the parties on April 1, 1986, that petitioner would not comply with said order because Universale refused to make said books and records available, after due consideration and pursuant to the memorandum sur order, dated March 12, 1986 (later published as an opinion of the Court, 86 T.C. No. 31 (March 26, 1986), it is

ORDERED: that petitioner is hereby precluded from offering into evidence at the trial of this case any books and records of Universale which reflect the premiums, losses, expenses and other items subject to the reinsurance treaty between petitioner and Universale and/or any evidence reflecting information derived fronm said books and records, including but not limited to the annual statements received by petitioner from Universale (sometimes referred to as the "Exercise" and "Technica Figures,") the publications of the Swiss Insurance Department, and the deposition of Horst Kurnik, taken on April 18, 1984, including the accompanying exhibits.

This order constitutes official notice to the parties of the contents.

(S) Theodore Tannenwald, Jr.
THEODORE TANNENWALD, JR
Judg

Dated: Washington, D.C.
April 9, 1986

H. K. PORTER COMPANY, INC., AND SUBSIDIARIES, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8237-84. Filed September 29, 1986.

Porter Australia, petitioner's wholly owned subsidiary, capitalized loans from petitioner and issued petitioner preferred stock. Approximately 10 years after Porter Australia issued the preferred stock, Porter Australia distributed all its assets in complete liquidation. The assets were distributed only with respect to the preferred stock, i.e., the assets did not cover the preferred stock's liquidation preference. No assets were distributed with respect to the common stock. *Held*, the liquidating distribution was not in complete cancellation or redemption of all Porter Australia's stock. *Held, further*, sec. 332 does not bar the recognition of petitioner's loss on the liquidation of Porter Australia. *Commissioner v. Spaulding Bakeries*, 252 F.2d 693 (2d Cir. 1958), affg. 27 T.C. 684 (1957), followed.

C. J. Queenan, Jr., *W. Henry Snyder*, and *David L. Ketter*, for the petitioner.

Edward J. Laubach, Jr., for the respondent.

OPINION

CLAPP, *Judge*: Respondent determined deficiencies in petitioner's 1978 and 1979 Federal income tax in the amounts of $105,281 and $745,161, respectively. After concessions, the issue for decision is whether section 332 applies to bar the recognition of gain or loss on the liquidation of H.K. Porter Australia, Pty., Ltd., petitioner's subsidiary.

This case was submitted under Rule 122, Tax Court Rules of Practice and Procedure. The stipulation of facts and the exhibits attached thereto are incorporated by this reference.

Petitioner H.K. Porter Co., Inc., and Subsidiaries is a Delaware business corporation. At the time it filed its petition in this case, petitioner's principal place of business was Pittsburgh, Pennsylvania.

In 1962, petitioner paid $219,336 for all of the outstanding stock of an Australian business corporation which manufactured saws, brake linings, and clutch facings. Petitioner changed the name of the corporation to H.K. Porter Australia, Pty., Ltd. (Porter Australia), and loaned Porter Australia the funds it needed to operate. At all relevant times, petitioner owned all of Porter Australia's outstanding stock.

In 1966, Porter Australia authorized 400,000 shares of $1 par common stock and 1 million shares of $1 par preferred stock. In 1968, it authorized 2 million additional shares of preferred stock.

The preferred stock only had voting rights at meetings convened to wind up the business, reduce its capital, sanction the sale of a business, or consider any question affecting the rights and privileges of the preferred stock. It had a 5-percent, noncumulative dividend, was redeemable, and had a $2,452,000 liquidation preference over the common stock.

In September 1966, and again in December 1968, Porter Australia capitalized loans from petitioner of $1 million and issued to petitioner 896,861 shares of preferred stock on each occasion. In November 1969, it capitalized loans from petitioner totalling $452,000 and issued petitioner 405,380 shares of preferred stock.[1] Porter Australia capitalized the loans because it was unable to "satisfy" the loans in the short term and it wanted to avoid any further claim by respondent that income should be allocated to petitioner by reason of those loans.

The chart below chronologically depicts when Porter Australia authorized/issued its new stock:

Date	*Authorized or issued*	*Number of shares*	*Loans capitalized*
8/66	Authorized	400,000 (common)	---
		1,000,000 (preferred)	---
9/66	Issued	896,861 (preferred)	$1,000,000
11/68	Authorized	2,000,000 (preferred)	---
12/68	Issued	896,861 (preferred)	1,000,000
11/69	Issued	405,380 (preferred)	452,000

In October 1978, petitioner's board of directors voted to terminate Porter Australia's operations because they were unprofitable, and dispose of all its assets. In May 1979, pursuant to Australian law, a certified liquidator was appointed to liquidate Porter Australia. In December 1979, petitioner surrendered all of its common and preferred stock in Porter Australia in exchange for a $477,876 liquidating distribution which included $10,288 to satisfy an intercompany receivable. Said distribution was not enough to cover the $2,452,000 liquidation preference of the preferred stock.

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[1] The record does not explain why the par value of preferred stock issued does not equal the amount of loans capitalized. We have followed the stipulation of the parties and the difference is immaterial to our conclusion.

As of December 31, 1978, petitioner's adjusted basis in its 182,664 shares of Porter Australia's common stock was $249,981. As of January 1, 1979, petitioner's adjusted basis in its 2,199,102 shares of Porter Australia's preferred stock was $2,425,358.[2]

On its 1978 and 1979 Federal income tax returns, petitioner claimed losses with respect to its Porter Australia stock. In his notice of deficiency, respondent disallowed said losses because "under I.R.C. Sec. 332, no gain or loss is recognized on the receipt of property distributed in complete liquidation of a subsidiary corporation."

Section 332(a)[3] provides that a corporation shall not recognize gain or loss on the receipt of property distributed in complete liquidation of another corporation.

Section 332(b) provides:

> SEC. 332(b). LIQUIDATIONS TO WHICH SECTION APPLIES.—For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if—
>
> (1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends);
>
> * * *
>
> (2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancella-

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[2] Again, the record does not explain why the adjusted basis of the preferred stock is different from the amounts of loans capitalized. We have followed the stipulation of the parties and the difference is immaterial to the conclusion.

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended.

tion or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; * * *

Respondent contends that section 332 bars the recognition of petitioner's losses. Petitioner contends that section 332 is inapplicable and cites *Spaulding Bakeries, Inc. v. Commissioner*, 27 T.C. 684 (1957), affd. 252 F.2d 693 (2d Cir. 1958).

In *Spaulding Bakeries*, the taxpayer purchased all the outstanding common and preferred stock of Hazleton Bakeries, Inc. between 1930 and 1946. In 1950, Hazleton Bakeries was liquidated and the taxpayer received the assets distributed in the liquidation. The distributed assets failed to cover the preferred stock's liquidation preference. No assets were distributed with respect to the common stock. On its 1950 Federal income tax return, the taxpayer claimed a worthless stock deduction with respect to the common stock. Respondent disallowed the deduction because of section 112(b)(6),[4] the predecessor of section 332. The sole issue for decision was whether section 112(b)(6) barred the recognition of the taxpayer's claimed losses. Specifically, the issue focused on whether Hazleton Bakeries distributed its assets in complete cancellation or redemption of "all its stock."

In a Court-reviewed opinion, we held that the phrase "all its stock" did not include "nonvoting stock which is limited and preferred as to dividends." 27 T.C. at 688. Thus, Hazleton Bakeries' distribution, which was in respect of only the nonvoting preferred stock, was not a distribution in complete cancellation or redemption of all its stock.

The Second Circuit, in affirming this Court, stated:

> The [taxpayer], it seems to us, argues with convincing force that the two classes of stock of Hazleton cannot be treated as though they were but one class, nor can the distribution in respect to the preferred stock

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[4] Sec. 112(b)(6) of the Internal Revenue Code of 1939 provided that no gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation if—

(A) the corporation receiving such property was * * * the owner of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends) * * * ; and

* * * * * * *

(C) the distribution is by such other corporation in complete cancellation or redemption of *all its stock*, * * * [Emphasis added.]

> be treated as though it were a distribution by Hazleton in respect to *all* its stock, all classes. It is convincingly argued as a matter of law, that there could be no distribution in respect to the common stock until the prior claim of the preferred stock had been satisfied. [252 F.2d at 697; emphasis in original.]

Respondent, in essence, advances two arguments: (1) *Spaulding Bakeries* was erroneously decided and the decision should be reconsidered; and (2) even under the rationale of *Spaulding Bakeries*, section 332 applies.

Spaulding Bakeries Reconsidered

Respondent contends that *Spaulding Bakeries* was erroneously decided because: (1) The phrase "all its stock" was misread as referring to only voting or common stock and not to nonvoting preferred stock; (2) an inappropriate analogy was constructed between preferred stock and indebtedness; and (3) the legislative history suggests that section 332 applies when a liquidating distribution is made on preferred stock only.

"all its stock"

In *Spaulding Bakeries* we stated:

> The statute is specific in that there must be a "distribution" in liquidation and the distribution must be "in complete cancellation or redemption of *all its [parent's] stock*." What does the phrase "all its stock" mean? Clearly it means at least 80 per cent of the common or voting stock. Does it also mean to include nonvoting stock which is limited and preferred as to dividends? We think not. The statute specifically excepts such preferred stock from the classes of stock which the parent should own—it could be owned by the parent or outsiders. * * * This means the payment in liquidation, in satisfaction of the preferred stock claim, whether to the parent or outsiders, will be immaterial. * * * Here there was no payment or distribution to the parent after the payment of the preferred stock claim in liquidation. The preferred stock claim captured all of the assets. There was nothing left to distribute to the parent as a common stockholder in the subsidiary. We hold the parent received no distribution in liquidation on its common stock within the intendment of the statute. Petitioner merely received in liquidation, payment of a part of its preferred stock claim—a fact which the statute, in effect, states will be immaterial. [27 T.C. at 688; emphasis added.]

In summary, we held that "its" referred to the parent's stock, i.e., the distribution had to be in complete cancellation or redemption of all the stock the parent owned in the subsidiary. Furthermore, because the parent had to own only 80 percent of each class of stock except nonvoting stock which was limited and preferred as to dividends, any distribution with respect to only the nonvoting preferred stock was "immaterial," i.e., not with respect to all the stock.

We agree with respondent that the phrase "all its stock" might be better interpreted as all *the subsidiary's* stock. Our decision, however, was not based on this analysis alone, and, as discussed below, we are not required to reach a different result.

Analogy Between Preferred Stock and Indebtedness

In *Spaulding Bakeries*, we cited cases which set forth the proposition that where the parent was the sole stockholder and also a creditor of the subsidiary, and the liquidating distribution to the parent was insufficient to satisfy the debt, the parent has both a deductible bad debt and a deductible stock loss. We analogized those cases to the facts in *Spaulding Bakeries*. We concluded that those cases were "authority for the conclusion that nothing was or could be 'distributed' on dissolution to the common stockholders until the full liquidation preference of the preferred stockholders was satisfied." 27 T.C. at 689.

Respondent contends that it was illogical to analogize preferred stock to indebtedness rather than to common stock. We disagree. We previously thought the analogy appropriate; the Second Circuit cited our analogy with approval; and we again find said analogy logical.

We further find that the Second Circuit aptly focused on the importance of priorities on dissolution. It stated, and we hold, that "the respective priorities of indebtedness over preferred and common stock and of preferred stock over common stock must be given full force and effect." 252 F.2d at 697. Here the assets were distributed with respect to the preferred stock. No assets were distributed with respect to the common. Consequently, the distribution was not a distribution with respect to all the subsidiary's stock.

Legislative History

Respondent contends that Congress orginally passed section 112(b)(6) because (1) the nonrecognition of gain or loss on the liquidation of a controlled subsidiary would encourage simplification of corporate structures, thereby destroying unnecessary holding companies, and (2) in actuality, the parent and subsidiary represent one unitary business venture and unification of such closely connected businesses should not be subject to tax consequences. Respondent further contends that the second reason, the unitary theory, supports him in the present case and cites the dissenting opinion in *Spaulding Bakeries*.

The majority opinion did not adopt the unitary theory in *Spaulding Bakeries*. The dissenting opinion adopted the theory. The Second Circuit concluded that "no help was afforded by a reading of the legislative reports." *Commissioner v. Spaulding Bakeries*, 252 F.2d 693, 697 (2d Cir. 1958).

Respondent gives us no new reason as to why the unitary theory, a theory implicitly rejected or accorded little weight by the Second Circuit and our majority opinion, should control the disposition of this case. He simply points to the dissenting opinion in *Spaulding Bakeries*. Suffice it to say that we are not persuaded. See *Commissioner v. Spaulding Bakeries, supra*.

Respondent also contends that the Senate Finance Committee report accompanying the enactment of the Internal Revenue Code of 1954 reflects congressional intent to minimize the elective features, and hence taxpayer manipulation, of section 332. Specifically, respondent cites a Finance Committee report which stated "Your committee has removed this provision with the view to limiting the elective features of the section." S. Rept. 1622, 83d Cong., 2d Sess. 255 (1954).

The provision referred to above prohibited the parent from selling any part of the subsidiary's stock between the time of adoption of the plan of liquidation and the time of distribution. See sec. 112(b)(6)(A), I.R.C. 1939. If a sale was effected, section 112(b)(6) would not apply. This provision, however, was deleted in 1954 upon the enactment of the Internal Revenue Code of 1954.

We cannot infer from the quoted excerpt, or respondent's purported fear of taxpayer manipulation, that Congress intended the result respondent seeks. See *Granite Trust Co. v. United States*, 238 F.2d 670, 679 (1st Cir. 1956), revg. 150 F. Supp. 276 (D. Mass. 1955). First, we decided *Spaulding Bakeries* in 1957. The Second Circuit affirmed in 1958. Congress has had ample opportunity to address any perceived taxpayer abuse spawned by *Spaulding Bakeries*.

Secondly, a manipulating taxpayer need not rely on *Spaulding Bakeries*. Section 332 has several requirements which can easily be avoided. See, e.g., *Commissioner v. Day & Zimmerman, Inc.*, 151 F.2d 517 (3d Cir. 1945), affg. a Memorandum Opinion of this Court (taxpayer sold stock to avoid 80-percent requirement); *Granite Trust Co. v. United States, supra* (taxpayer made gift and sale of stock to avoid 80-percent requirement).

Notwithstanding Spaulding Bakeries, Does Section 332 Apply?

Respondent alternatively argues that section 332 applies, even under the rationale of *Spaulding Bakeries*, because: (1) Porter Australia's preferred stock had voting rights and, therefore, the distribution in the present case cannot be considered "immaterial;" and (2) substance prevails over form and, here, petitioner in substance held only one class of stock.

Porter Australia's Preferred Stock

Respondent focuses on the voting rights of Porter Australia's preferred stock.[5] We need not. We agree that the Second Circuit's analysis was correct in that priorities on dissolution cannot be disregarded. In the instant case, Porter Australia's preferred stock had a liquidation preference. In satisfying that preference, no assets remained to distribute with respect to the common stock. Thus, the distribution was not in cancellation or redemption of *all* its stock.

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[5] The preferred stock in *Spaulding Bakeries* was treated as nonvoting even though, as in this case, it had certain limited voting rights on matters which affected it.

Substance Over Form

Respondent contends that the substance of the transaction indicates that petitioner held only one class of stock which, when so viewed, would render Porter Australia's liquidating distribution subject to section 332 even under the rationale of *Spaulding Bakeries.* In support of his position, he states that Porter Australia's preferred stock did not grant petitioner any benefits or privileges that it did not already possess as the only stockholder in Porter Australia.

In *Weiss v. Stearn,* 265 U.S. 242, 254 (1924), the Supreme Court stated:

> Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form.

In the instant case, petitioner loaned Porter Australia money which Porter Australia needed to operate. Porter Australia capitalized the loans and issued preferred stock in 1966, 1968, and 1969 because it was unable to satisfy the loans in the short term and it wanted to avoid any further claim by respondent that income should be allocated to petitioner by reason of those loans. In 1979, petitioner received the liquidating distribution with respect to its preferred stock.

The preferred stock issued in 1966, 1968, and 1969, approximately 10 years before Porter Australia liquidated, was not "illusory" or part of a financial facade constructed of shuffled papers. Cf. *Gregory v. Helvering,* 293 U.S. 465 (1935) (transaction in form of corporate reorganization was just an elaborate conveyance). Significant consequences attached to petitioner's decision to capitalize the loans. Petitioner capitalized the loans with preferred stock, not common. We need not know why petitioner issued preferred stock instead of common. See *Granite Trust Co. v. United States, supra.* What is important here is that Porter Australia authorized and issued preferred stock with specific rights and privileges. Respondent has not argued that those rights and privileges have been ignored and the record does not suggest such a finding. We find that the preferred stock was exactly what it purported to be—preferred stock.

Respondent cites *Gamman v. Commissioner*, 46 T.C. 1 (1966). In that case, respondent relied on the "so-called thin capitalization cases" to argue that the taxpayer did not qualify as a small business corporation under subchapter S because the taxpayer's loans were actually a second class of stock. Both the analysis and facts are different from those in the present case. Under the facts and circumstances of *Gamman*, we held that the notes were a nullity, constituting neither a true debt obligation nor a second class of stock. Here we find that the preferred stock was real and entitled to be treated in accordance with its terms.

Finally, because we have held that section 332 does not bar the recognition of petitioner's losses, we hold that, based on the record, petitioner is entitled to an ordinary loss of $249,981 in 1978 with respect to the worthlessness of its common stock and a long-term capital loss of $1,957,770 in 1979 with respect to its preferred stock. See sec. 165(a) and (g).

Decision will be entered under Rule 155.

BERNARD A. LEVIN AND PHYLLIS LEVIN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ALAN T. HRABOSKY AND DELORES Y. HRABOSKY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 19971-83, 19999-83. Filed September 29, 1986.

Ps were limited partners in Israeli partnerships formed in December 1979 to develop, manufacture, and market certain food-packaging machinery systems. Each partnership executed, on the same day, a development agreement, a manufacturing agreement, and a marketing agreement with respect to each system. Under the development agreements, the partnerships agreed to pay D, an Israeli corporation, certain amounts, stated in Israeli currency, to develop the systems

into manufacturable and marketable products. Approximately one-fourth of the development fees was payable immediately in cash. The remainder of such fees, called periodic payments, was payable, with interest of 10 percent per annum through 1982 and 8 percent thereafter, 50 percent in 1994 and 50 percent in 1995, unless sooner paid through a fixed percentage of the gross revenues from sales of the systems. The periodic payments liabilities were not linked to either the Israeli consumer price index or the value of a foreign currency, such as the U.S. dollar. D entered into a consulting agreement regarding each system with another Israeli corporation, T, whereby T would receive 95 percent (less D's expenses and amounts paid to other Israeli subcontractors) of the development fees in return for developing the systems. Under the manufacturing agreements and marketing agreements, the partnerships granted T the exclusive rights to manufacture, use, and market the systems, in return for certain manufacturing and marketing fees. The manufacturing agreements would terminate in 2027, and the marketing agreements would terminate in 2008. Employing the accrual method of accounting, the partnerships claimed deductions under sec. 174(a), I.R.C. 1954, for the U.S. dollar values of the entire amount of their development fees liabilities at exchange rates in effect in December 1979. The partnerships also claimed deductions for the accrued interest on the periodic payments liabilities and for certain miscellaneous expenses. *Held*:

1. The partnerships' liabilities to D for research and development were not paid or incurred in connection with trades or businesses within the meaning of sec. 174(a) and therefore are not deductible under such section.

2. The periodic payments liabilities served no economic purpose beyond generating deductions for research and experimental expenses and interest expenses, and therefore, the interest accrued thereon is not deductible.

Sheldon Chertow, *Lloyd E. Shefsky*, *Martin M. Lucente, Jr.*, *Clifford E. Yuknis*, and *Joel J. Sprayregen*, for the petitioners.

Thomas C. Borders and *William E. Bogner*, for the respondent.

SIMPSON, *Judge*: The Commissioner determined deficiencies in the petitioners' Federal income taxes for 1979 as follows:

Docket No.	*Petitioner*	*Deficiency*
19971-83	Bernard A. and Phyllis Levin	$18,633
19999-83	Alan and Delores Hrabosky	61,976

The issues for decision are: (1) Whether the expenditures by certain partnerships formed for the stated purpose of developing, manufacturing, and marketing certain food-packaging machinery were paid or incurred in connection with a trade or business within the meaning of section 174 of the Internal Revenue Code of 1954[1]; and (2) whether the interest on certain long-term obligations payable in Israeli currency is deductible.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.[2]

When they filed their petitions in these cases, the petitioners Bernard A. and Phyllis Levin, husband and wife, resided in Skokie, Illinois, and the petitioners Alan and Delores Hrabosky, husband and wife, resided in Lithonia, Georgia. Mr. and Mrs. Levin and Mr. and Mrs. Hrabosky filed their Federal income tax returns for 1979 with the Internal Revenue Service Center, Kansas City, Missouri.

In 1972, Ihor Wyslotsky, a mechanical engineer and an expert in the design of packaging machinery, founded Thermoplastics Engineering Co., Inc. (TEC). TEC, an Illinois corporation, was headquartered in Posen, Illinois, until 1979, when the company was reincorporated under the laws of the State of Delaware as TEC, Inc., and its administrative, engineering, and manufacturing facilities were moved to Alsip, Illinois. During its first 6 years, TEC designed and manufactured specialized and highly sophisticated packaging machinery for customers in the food and pharmaceutical industries. Each piece of equipment was one of a kind, being designed to meet the particular needs of the customer. The projects usually were funded by the customer on a fixed-price basis. TEC customers during this period included Carl Buddig & Co., 3M Co., Abbott Laboratories, Baxter Travenol Laboratories, Inc., and Rexham Corp.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

[2] On brief, the petitioners have occasionally relied on answers to certain interrogatories to support an argument. Under Rule 70(d) of the Tax Court Rules of Practice and Procedure, answers to interrogatories "will not be considered as evidence" and are admissible "to the extent permitted by the rules of evidence." We decline to make findings of fact based on the answers to interrogatories cited by the petitioners because such answers have not been offered and received into evidence. Moreover, the Commissioner has not been offered an opportunity to examine the party who answered the interrogatories.

In 1975 or 1976, Mr. Wyslotsky sold a 25-percent interest in TEC to Lloyd Shefsky. Mr. Shefsky, a member of the Chicago law firm of Shefsky, Saitlin & Froelich, Ltd., and a certified public accountant, was legal counsel to Mr. Wyslotsky, TEC, and TEC-affiliated companies. By 1979, Mr. Wyslotsky owned 51 percent and Mr. Shefsky owned 49 percent of TEC's outstanding shares of stock.

Together, Messrs. Wyslotsky and Shefsky developed a long-range plan for TEC. They decided that TEC should use its expertise in the design of specialized packaging machines to develop a series of standardized, mass-producible packaging machines. The machines would incorporate the newest technologies (such as lasers and microprocessors) to achieve greater efficiencies and cost savings in the packaging of food and pharmaceuticals, processes which theretofore had been highly inefficient and not innovative. Initially, TEC would focus on machines for the meat packing industry because that industry had high packaging costs and very low profit margins; any packaging cost savings would translate directly into significantly higher profits, making TEC's machines attractive to the industry. TEC planned, eventually, to modify its packaging machines for use in the cheese and pharmaceutical industries.

In 1977 and 1978, TEC used its own funds to develop the TEC 1001, a high-speed vacuum packaging machine for luncheon meats and frankfurters. TEC began manufacturing and selling the TEC 1001 in 1978. TEC did not have the substantial amounts of money needed to develop the other machines which were to form its product line. TEC investigated the possibility of financing the development through financial institutions and certain Government programs in the United States and Israel, but for various reasons, its attempts to secure such funding were unsuccessful. At Mr. Shefsky's suggestion, TEC eventually decided to raise the necessary funds through "off-balance-sheet" financing. The general features of this financing technique were described as follows in a "Report and Investment Proposal" prepared by TEC in December 1980:

> FINANCING TECHNIQUES
>
> On several occasions in the past, the company has allowed individual investors or groups of investors to contract with the company for the development of particular equipment or systems. Typically, these contracts entailed agreements whereby the investors would generate the cash necessary for the development of the desired equipment and systems, and, subsequently would own all right, title and interest to that equipment. Therefore, a substantial portion of the TEC product line technically is owned by outside investors and investor groups. TEC has long-term (40 years) contracts with these outside investors and investor groups, whereby TEC is granted total and exclusive manufacturing and marketing rights. The income accruing to the outside investors and investor groups have not been reflected in the projected financial statements included in this report, and would not accrue to the benefit of TEC.

The development investment programs were structured in an attempt to provide maximum tax incentives to the investors.

In 1978, TEC used its off-balance-sheet financing technique to obtain development funds for three projects: (1) The slice, weigh, and pack (SWAP) system for bacon packaging; (2) the dieless vacuum packaging system, which would produce semi-rigid and flexible packaging for a variety of products; and (3) the tent-pak system, which would produce a recloseable package for luncheon meat and cheese. The outside investors who provided the money for the development of these three systems entered into development, manufacturing, and marketing agreements with companies owned by or affiliated with (through common ownership by Messrs. Wyslotsky and Shefsky) TEC and incorporated in the United States.

TEC obtained development funds for additional packaging machine systems in a slightly different fashion in the 4 years following 1978. The individual American investors purchased limited partnership interests in Israeli partnerships, which, in turn, entered into development, manufacturing, and marketing agreements with Israeli companies (including TEC affiliates) for particular pieces of equipment that TEC wished to add to its product line. The structure of the research and development investments involved in the present case was typical of those promoted by TEC in 1979 and thereafter.

Dispoard (Israel) & Co. (Dispoard) was organized as an Israeli limited partnership, and Labless (Israel) & Co. (Labless) was organized as an Israeli general partnership, in December 1979. Both partnerships are to terminate in the year 2009, unless sooner terminated by a vote of the partners or upon the occurrence of certain stated events.

Dispoard had one general partner, Mimi J. Ben-Gershon, an Israeli citizen, and nine limited partners. A total of $255,000 was contributed to the capital of Dispoard; $138,000 was contributed in 1979 and $117,000 was contributed in 1980. The general partner made no capital contribution. The limited partners subscribed for a total of 138 "class A" units and 117 "class B" units at a price, which was stated in U.S. dollars, of $1,000 each. The price of the class A units was payable upon subscription, and the price of the class B units was payable upon notification that an engineering benchmark had been reached in the development of a bacon board dispenser, which event was expected to occur in May 1980. According to Dispoard's private placement memorandum, the partnership's entire capital of $255,000 was to be expended as follows:

Use of proceeds	
Development fees (including legal fees of $20,000)	$228,000
Financial advisory fees	20,000
General partner's compensation and office expense	1,000
Other expenses	6,000
Total	255,000

Labless had four general partners: Taryl B.G., Ltd. (Taryl), and three Israeli limited partnerships. Taryl, an Israeli corporation,[3] was organized shortly before Labless was formed. The record does not reveal the owner or owners of Taryl. Ms. Ben-Gershon signed the partnership agreement on behalf of Taryl. The three limited partnerships were named Labless Achad & Co. (Achad), Labless Shtayim & Co. (Shtayim), and Labless Shalosh & Co. (Shalosh). Ms. Ben-Gershon was the general partner of each of the limited partnerships. The limited partners of Achad, Shtayim, and

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[3] The term "corporation" does not exist under Israeli law. However, the Israeli limited companies involved in this case were essentially equivalent to corporations, and for convenience, we shall refer to them as such.

Shalosh subscribed for a total of 632 "class A" and "class B" units at a price, which was stated in U.S. dollars, of $1,000 each. The price of the class A units was payable upon subscription, and the price of the class B units was payable upon notification that certain engineering benchmarks had been reached in the development of a label dispenser and applicator (labeler) and a semi-rigid materials thermoformer system (thermoformer), which benchmarks were expected to be reached in May 1980. The limited partnerships contributed a total of $632,000 to the capital of Labless, as follows:

	Achad	*Shtayim*	*Shalosh*
1979 capital contribution (class A units)	$107,000	$93,000	$89,000
1980 capital contribution (class B units)	126,000	100,000	117,000

Taryl made no capital contribution to Labless, and Ms. Ben-Gershon made no capital contributions to the limited partnerships. According to Labless' private placement memorandum, its entire capital of $632,000 was to be expended as follows:

Use of proceeds	
Development fees (including legal fees of $50,000)	$542,000
Sales commissions	42,000
Reserve for patents and tax defense	34,000
General partner's compensation and office expense	3,000
Other expenses	11,000
Total	632,000

Because the sole activity of Achad, of Shtayim, and of Shalosh was to invest in Labless, we shall hereinafter, for convenience, refer to Ms. Ben-Gershon as the general partner of Labless and to their limited partners as partners in Labless.

In 1979, the petitioner Alan Hrabosky subscribed for 30 class A units and 15 class B units in Dispoard, and the petitioner Bernard A. Levin subscribed for 10 class A units and 1 class B unit in Labless. Incident to acquiring such units, each petitioner was required to sign a subscription agreement whereby each agreed, in pertinent part:

> to be personally liable to the Developer under the Development Agreement[4] to be entered into between the Venture and the Developer for a

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[4] This read "Development Agreements" in the Labless subscription agreements.

> portion of the Development Fees designated as Periodic Payments being paid no later than January 31, 1994.[5] That portion of the Undersigned's liability for such fees shall be limited to an amount equal to the sum of (i) the number of the Undersigned's Class A Units times 85,714 Israeli Pounds; plus (ii) the number of the Undersigned's Class B Units times 104,348 Israeli Pounds. (For comparative purposes, at present exchange rates, approximately 33 Israeli Pounds are equivalent to One Dollar[.]) Any amount which the Undersigned is required to pay to creditors of the Venture, to contribute to the Venture, or to pay to any other person as a result of his personal liability hereunder shall constitute an additional capital contribution to the Venture.[6]

The Dispoard and Labless partnership agreements granted Ms. Ben-Gershon, as general partner, full, exclusive, and complete authority and discretion in the management and control of the affairs of the partnerships. For 2½ years after the formation of the partnerships, she was to receive a monthly fee for supervising the partnerships' affairs. In addition, she was entitled to 1 percent of each partnership's net profits and losses. The record contains no evidence of Ms. Ben-Gershon's educational or business qualifications beyond the facts that she was an Israeli citizen and that she was the general partner of every Israeli partnership promoted by TEC. She did not testify at the trial of this case.

The partnership agreements of both Dispoard and Labless recited that they were formed for the purpose of engaging in the business of developing, manufacturing, and marketing food-packaging machinery and equipment. However, the partnerships' private placement memorandums explained that Dispoard's business was to be limited to the development, manufacture, and marketing of the bacon board dispenser, and that Labless' business was to be limited to the development, manufacture, and marketing of the labeler and the thermoformer if, as occurred, investors subscribed for 632 partnership units.

The bacon board dispenser was intended to produce and to dispense a bacon board that Mr. Wyslotsky had invented and for which he obtained a patent in 1981. (He applied for the patent in October 1979.) A bacon board is a stiff piece of plastic onto which bacon is deposited during the bacon slicing operation. The proposed bacon board dispenser was to feed rollstock bacon board material into a simple reciprocating cutting head that would produce the board, and then it was to feed the cut boards on demand directly under the delivery end of the output conveyer of the bacon slicer.

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[5] Under the development agreements as executed, only 50 percent of the periodic payments was payable by Jan. 31, 1994; the remaining 50 percent was due by Jan. 15, 1995. See text p. *infra*.

[6] This read "capital contribution to the Partnership" in the Labless subscription agreements.

The labeler was to apply labels, a pre-printed band of film, to the flexible packaging material used on a packaging machine. The band of film was to be fused to the packaging material with temperature-sensitive adhesives so as to become an integral part of the packaging material.

The thermoformer was intended to be an optional accessory to the dieless machine. The thermoformer was to form a semi-rigid package of uniform thickness using thinner-gauge plastics than is required by existing thermoforming technology, thereby reducing film waste. Four sub-systems would comprise the thermoformer system: a pressure former, a vacuum former, a microprocessor, and software. The microprocessor was to be equipped to receive various computer programs (the software) for different applications of packaging films. Together, the software and microprocessor would control all aspects of the thermoforming process.

On December 19, 1979, Dispoard entered into a set of agreements relating to the bacon board dispenser, and Labless entered into two sets of agreements, the first set relating to the labeler and the second set relating to the thermoformer. Each set included the following agreements: (1) A development agreement, (2) a manufacturing agreement, and (3) a marketing agreement. The sets of agreements are virtually identical, the chief differences being the machine to be developed and the amounts of the development, manufacturing, and marketing fees. In all of the agreements, the machine involved (bacon board dispenser, labeler, or thermoformer) was referred to as a "system."

Under the development agreements, Development & Manufacture Control Ltd. (DMC), an Israeli corporation, agreed to provide Dispoard and Labless with research and development services, technical documentation, and a single operating prototype model of each system,

> which may be suitably constructed to be capable of functioning as part of an overall group of materials handling and packaging machinery and equipment as may be required by Owner's [the partnership] first customer for the System. It is further contemplated and agreed that, while said prototype shall be usable within such group of machinery and equipment, the System shall be adaptable, with minor modifications, to the full spectrum of functions and capacities set forth

in an attached description of the system. DMC further agreed to indemnify each partnership from any claim or liability arising out of the use of the system(s) by any purchaser or licensee, or arising from or by reason of any actual or claimed infringement of any patent, trademark, or copyright, provided DMC was promptly notified of the infringement allegation and was given the opportunity to assume sole control over the defense or compromise of the infringement action. DMC also agreed to provide each partnership with quarterly progress reports on the results of its activities. While DMC was required to use its "best efforts to complete the development of the System," the parties to the agreement "understood and agreed that such completion shall be satisfied by Developer's [DMC] best efforts, including the expenditure of the amounts payable by Owner pursuant to the terms and provisions of this Agreement." The development agreements gave Dispoard and Labless no power to supervise the activities of DMC with respect to their systems.

In return for its services, DMC was to be paid development fees as follows:

	DISPOARD	LABLESS	
	Bacon board dispenser	*Labeler*	*Thermoformer*
First stage:			
Initial payment	[7]I£4,020,000	I£4,288,000	I£3,752,000
Periodic payments	11,558,000	12,868,000	11,336,000
Total first stage fees	15,578,000	17,156,000	15,088,000
Second stage:			
Initial payment	4,536,000	6,804,000	5,880,000
Periodic payments	12,285,000	19,148,000	16,868,000
Total second stage fees	16,821,000	25,952,000	22,748,000
Total development fees	32,399,000	43,108,000	37,836,000

All payments due DMC under the development agreements were payable in Israeli pounds or, in the event Israel changed its official currency, in such subsequent Israeli currency. If the currency was changed, any amounts due would be restated in the new currency using the conversion terms established by the Israeli Government.

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[7] Israeli pound.

The first stage initial payment was due on December 20, 1979. Payment of the second stage development fees (initial and periodic payments) was contingent upon completion of the "Second Stage Benchmark," which for all three systems was the completion of soft engineering.[8] According to the partnerships' private placement memorandums, such benchmark for all three systems was expected to be reached in May 1980. The first stage periodic payments and (if the benchmark was obtained) the second stage periodic payments, together with accrued interest thereon, were payable from "all gross revenues received by or on behalf of Owner from the sale, (net of sales, use, and similar taxes and returns and allowances) lease, license, transfer, assignment or other disposition or exploitation of the System" at the "Payment Percentage" rate set forth in each agreement. Such rate was as follows for the three systems:

	Payment percentage
Dispoard	
Bacon board dispenser	21
Labless	
Labeler	16
Thermoformer	15

The development fees bore interest at the rate of 10 percentper annum in 1979, 1980, and 1981, and 8 percent per annum in 1982 and thereafter, commencing on the date the obligation to pay such fees arose and accruing until such fees were paid. Any payments made pursuant to the development agreements were to be applied first to the interest and thereafter to the fees due.

Dispoard and Labless were in any event unconditionally obligated to pay 50 percent of the periodic payments, and any accrued but unpaid interest thereon, by January 31, 1994, and the remaining 50 percent of such payments and interest by January 15, 1995. Moreover, the development agreements provided:

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[8] "Soft engineering" refers to the devising of ideas or concepts, and it precedes the preparation of drawings and bills of materials.

5. *Payment.*

* * * * * *

IV. As a condition of Developer's willingness to receive payment of the Total Development Fees from time to time, as provided in this Agreement, Owner covenants to require each limited partner of Owner to become personally responsible for a portion of the Total Development Fees due Developer hereunder. The liability of each limited partner shall be limited to that portion of the Total Development Fees equal to the limited partner's percentage interest in Owner.[9]

DMC's right to receive the development fees payable under each agreement was secured by a security interest in, and general lien upon, the system covered by the agreement and the products and proceeds of the system's use and exploitation. Each development agreement was to terminate by January 15, 1995.

In 1980, the State of Israel changed its official currency from the pound to the shekel. At the official conversion rate of 10 pounds to 1 shekel, the partnerships' liabilities to DMC for the periodic payments converted to shekels (IS) as follows:

	DISPOARD *Bacon board dispenser*	LABLESS *Labeler*	 *Thermoformer*
First stage: Periodic payments	IS1,155,800	IS1,286,800	IS1,133,600
Second stage: Periodic payments	1,228,500	1,914,800	1,686,800
Total periodic payments	2,384,300	3,201,600	2,820,400

Under the manufacturing agreements, each partnership granted TEC Packaging (Israel), Ltd. (TEC Packaging), an Israeli corporation, the exclusive right to manufacture its system(s). Each agreement was effective upon execution and was to terminate on December 31, 2027. For manufacturing a system, TEC Packaging was to be paid a percentage of each system's "Suggested Retail Price":

	Percentage	*Initial suggested retail price*
Dispoard Bacon board dispenser	44	I£1,507,500
Labless Labeler	53	1,005,000
Thermoformer	55	1,273,000

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[9] In Lables' development agreements for the labeler and the thermoformer, the first sentence of sec. 5.IV. read "each limited partner *of the participants* of Owner," and the second sentence of such section read "the limited partner's *effective* percentage interest." (Emphasis added.)

Paragraph 4 of each agreement provided that such manufacturing cost was to be paid in installments of 30 percent upon order, 60 percent upon physical delivery and inspection of the system, and 10 percent within 30 days of installation and acceptance of the system. If the partnership received payments from its customers in excess of the installments required to be paid TEC Packaging, such excess, less any commissions, was to be paid to TEC Packaging until it had received 90 percent of the manufacturing cost. Each manufacturing agreement further provided that the suggested retail price established in the agreement could not be reduced by more than 5 percent during any 12-month period without TEC Packaging's prior written consent. Finally, TEC Packaging was not obligated to manufacture a system if its price fell below a price at which it was "commercially practical" for TEC Packaging to manufacture the system. If TEC Packaging elected not to manufacture under such circumstances, the partnership could retain another manufacturer, but only if the other manufacturer charged no more than TEC Packaging.

Under the marketing agreements, each partnership granted TEC Packaging the exclusive, worldwide right to market its system(s) either directly or through the use of agents, independent contractors, or representatives. Each partnership agreed that it would not, during the term of the marketing agreement, market or use, or authorize any other person, firm, or entity to market or use the system or any part thereof. TEC Packaging was obligated to use its best efforts to actively build, maintain, and expand the market for each system. It was also obligated to pay all marketing costs and expenses that it incurred.

In return for its marketing services, TEC Packaging was to receive, as a sales commission, an amount equal to 15 percent (the initial percentage) of an initial amount (the marketing achievement level) of the gross revenues received by, or collected on behalf of, each partnership from the marketing of its system. When the marketing achievement level for each system was reached, TEC Packaging's sales commission was to rise to a greater percentage (the achievement percentage) of the system's gross revenues.

The systems' marketing achievement levels and achievement percentages were as follows:

	Marketing achievement level	*Achievement percentage*
Dispoard		
Bacon board dispenser	I£155,925,000	27
Labless		
Labeler	276,375,000	27
Thermoformer	308,736,000	25

TEC Packaging was authorized to collect all gross revenues and to pay from such revenues all manufacturing costs, on behalf of each partnership. After it had received sufficient revenues to completely pay for the manufacturing costs, TEC Packaging was entitled to withhold its commissions and then to remit the balance of the revenues to the partnership. The marketing agreements were effective upon execution and were to terminate on December 31, 2008.

Each development, marketing, or manufacturing agreement expressly provided that no agency, partnership, or joint venture was to exist between the parties to the agreement.

On the same day as the partnerships entered into the development agreements with DMC and the manufacturing and marketing agreements with TEC Packaging, DMC and TEC Packaging executed a consulting agreement with respect to each of the development agreements. Under the consulting agreement, TEC Packaging agreed "to use its best efforts to assist Developer [DMC] to complete the development" of a system by providing technical services and documentation, and by assisting DMC in the construction of a prototype model of the system. TEC Packaging further agreed to furnish DMC with quarterly progress reports of its activities. In return for such services, DMC agreed to pay TEC Packaging a consulting fee, payable in Israeli pounds (or subsequent Israeli currency) of 95 percent of all development fees payable to DMC pursuant to each development agreement less (1) reasonable direct expenses incurred by DMC in connection with the project and (2) payments made to Israeli subcontractors other than TEC Packaging. The consulting fee was due no later than 5 days after DMC received the development fees. Each consulting agreement was to terminate upon completion of a prototype model, which for all three systems was to be no later than December 31, 1981.

On or about May 30, 1980, DMC and TEC Packaging amended the consulting agreements to provide that TEC Packaging was to be paid the following consulting fees in lieu of those specified in their original agreements: (a) 95 percent of the initial payments payable to DMC pursuant to the development agreements less (1) reasonable direct expenses incurred by DMC in connection with the projects and (2) payments made to Israeli subcontractors other than TEC Packaging; and (b) 100 percent of the periodic payments payable to DMC pursuant to the development agreements less "such reasonable compensation to be agreed upon by the parties at the time of said payments." By September 1980, DMC and TEC Packaging agreed that "such reasonable compensation" would amount to 5 percent of the periodic payments, so that DMC would pay TEC Packaging 95 percent of the deferred payments.

TEC Packaging was organized and owned in 1979 by Messrs. Wyslotsky and Shefsky. TEC Packaging used the cash method of accounting. It was established because Mr. Wyslotsky felt that TEC should maintain a presence in Israel. TEC had begun subcontracting development work on the SWAP and dieless systems with an Israeli engineering firm in 1978, and Mr. Wyslotsky planned to subcontract some of the work on the bacon board dispenser, labeler, and thermoformer to Israeli firms. Mr. Wyslotsky intended TEC Packaging to oversee the development projects and, eventually, to manufacture the developed products in Israel and to export them from Israel to the United States and Europe. His objective was to develop and manufacture the high-technology components of TEC's packaging systems in Israel because engineering expertise was readily available at a lower cost in Israel and because the Government of Israel offered financial assistance to manufacturers.

On the advice of TEC's Israeli lawyers and accountants, it was later decided that the manufacturing would be done by an Israeli corporation using the accrual method of accounting; TEC Equipment (Israel), Ltd. (TEC Equipment), was officially registered as an Israeli corporation in January 1980 and, at that time, was owned by Messrs. Wyslotsky and Shefsky. Subsequently, in 1981, they assigned their interests in TEC Equipment and TEC Packaging to TEC. In 1983, the partnerships, TEC Packaging, and TEC Equipment entered into an "assumption and release" agreement with respect to each manufacturing agreement whereby TEC Equipment assumed, with the partnerships' approval, all of TEC Packaging's rights and duties under the manufacturing agreement.

DMC was formed in December 1979 and used the accrual method of accounting. The company was owned by two brothers, Itzhak and Shmuel Bezalel, and members of their families. Itzhak Bezalel was an accountant, and Shmuel Bezalel was an economist. Both resided in Israel and held full-time jobs unconnected with DMC in 1979 and thereafter. A third brother, Benzion Bezalel, served as a consultant to DMC on the management of the research and development projects.

Benzion Bezalel was an industrial and management engineer and was experienced in the management of research and development projects in Israel. When Mr. Wyslotsky met him in 1977, Benzion Bezalel was employed in Chicago as the Israeli Consul of Economic Affairs for the midwest region of the United States. Mr. Wyslotsky initially attempted to persuade Benzion Bezalel to work for TEC Packaging; but when Mr. Bezalel made salary and stock ownership demands that Mr. Wyslotsky thought excessive, they agreed that Mr. Bezalel would assist TEC in Israel through an Israeli corporation, DMC, to be owned by Mr. Bezalel's brothers.

The principals of TEC and DMC never intended for DMC to actually perform any development work. Instead, DMC's role in these, and in all the other Israeli research and development investments promoted by TEC, was to assist TEC in negotiating and administering research and development subcontracts with Israeli engineering firms, to disburse the partnerships' development funds to TEC Packaging and Israeli subcontractors, and, in Benzion Bezalel's words, "to manage [the] tax operation in Israel."

It cannot be definitely ascertained from the record how the partnerships' capital was expended. According to the records of DMC, through September 1981, it received development fees (which did not include any periodic payments) and made disbursements to itself, to Israeli subcontractors, and to TEC Packaging as follows:

	DISPOARD	LABLESS	
	Bacon board dispenser	*Labeler*	*Thermoformer*
Received	$228,002.09	$251,926.37	$289,915.26
DMC	14,560.00	15,890.00	18,550.00
To Israeli subcontractors	31,231.88	20,072.62	121,500.00
To TEC Packaging	181,001.65	214,291.52	134,621.19
Unexpended in September 1981	1,208.56	1,672.23	15,244.07

Most of the money paid to TEC Packaging by DMC, pursuant to the consulting agreements, was then paid over to TEC. TEC spent the money in the United States on the direct development costs (materials, labor, factory overhead) that it incurred in connection with each system and on a portion of its general and administrative expenses that it allocated to each system. No written contract existed between TEC Packaging and TEC; TEC merely billed TEC Packaging as it incurred expenses relating to the systems.

TEC completed development of the labeler by July 15, 1981, and the thermoformer by July 31, 1982. However, the bacon board dispenser was never completed because TEC ran short of funds in 1981 and 1982. Since it had advance orders from customers for the dieless system, labeler, and thermoformer, TEC gave the development of those projects top priority.

TEC controlled the marketing of the labeler and the thermoformer. It marketed the products as part of the larger, integrated TEC packaging machinery system and under the "TEC" tradename. There is no evidence that Ms. Ben-Gershon, as general partner of the partnerships, was ever, in any way, involved in the marketing of the systems or in establishing their sales prices or the terms of their sale.

TEC eventually sold two labelers at $30,000 each and three thermoformers at $40,000 or $45,000 each. After the sale of the first labeler, in October 1982, TEC paid a total of $9,600 to Labless. The $9,600 represented the balance of the $30,000 sales price remaining after subtraction of the 53-percent manufacturing fee ($15,900) and 15-percent marketing fee ($4,500) due TEC Packaging. TEC transferred $4,800 of the $9,600 to Labless' Israeli bank account for distribution to DMC as a periodic payment of IS141,616.08, pursuant to the labeler development agreement. However, for some unknown reason, only $4,697.15 was transferred to DMC. In accordance with the labeler consulting agreement, DMC paid the entire $4,697.15 periodic payment to TEC Packaging. TEC transferred the second half of the $9,600 to Mr. Shefsky's law firm, which then distributed $4,752 to Labless' limited partners and directed Ms. Ben-Gershon to withdraw $48 (apparently from Labless' Israeli bank account) as her 1-percent distribution. Mr. Levin received a distribution of $83.54.

TEC made no payments to, or on behalf of Labless, in connection with its sales of the second labeler and the three thermoformers. In May 1983, Allstate Insurance Co. (Allstate) and Hambro America, Inc. (Hambro), which in 1981 had invested $2 million in TEC, obtained a controlling interest in the company in return for their agreement to invest more money. As part of the agreement, Messrs. Wyslotsky and Shefsky resigned as officers and directors of TEC and its affiliated companies. A new chief executive officer was installed at TEC, and he, after consultation with Allstate and Hambro, decided that after the first labeler payment, TEC would make no further payments to Labless with respect to later sales of the labeler and thermoformer because TEC had lost money on the sales due to equipment failures that it had had to correct at its own expense. There is no evidence that Ms. Ben-Gershon or any of Labless' limited partners ever inquired about, or pursued any legal action with respect to, the payments to which Labless was entitled.

As a part of the agreement whereby Allstate and Hambro gained control of TEC, TEC assigned all of its rights and those of its subsidiaries (TEC Packaging and TEC Equipment) under the manufacturing, marketing, and consulting agreements for the bacon board dispenser and the thermoformer to a newly formed corporation owned by Mr. Wyslotsky. Dispoard and Labless were not involved in the negotiation of the assignments; as a part of the agreements to assign the contracts to his new firm, Mr. Wyslotsky agreed to secure the partnerships' approval. No assignment of the labeler contracts was made in 1983, although Mr. Wyslotsky and TEC were discussing such an assignment at the time of trial.

Allstate invested additional money in TEC in 1983 after Allstate and Hambro gained control of the company. Eventually, they sold TEC to an established company.

Ms. Ben-Gershon's activities on behalf of Dispoard and Labless were not substantial. She executed all of the development, manufacturing, and marketing agreements on behalf of the partnerships, but she did not negotiate their terms. She maintained bank accounts in Israel for each of the partnerships. She paid bills submitted by TEC's Israeli lawyers and accountants for their services in connection with the partnerships (although Mr. Wyslotsky determined how the legal expenses were to be allocated among the several partnerships for which they were performed). According to Benzion Bezalel, Ms. Ben-Gershon "showed a lot of interest" in the development of the systems. Because she was interested in learning about the meat packaging industry, in 1979, Mr. Wyslotsky assisted her in obtaining trade magazines and technical articles and accompanied her on a tour of a meat packing house in Israel. On one occasion, she went with Mr. Wyslotsky when a subcontract with an Israeli engineering firm was negotiated.

The liabilities of Dispoard and Labless for the development fees payable as periodic payments in Israeli pounds (subsequently shekels) were not indexed for inflation (i.e., linked to changes in the Israeli consumer price index) or linked to the exchange rate of any foreign currency, including the U.S. dollar. The chart below sets forth the inflation rate (December to December and rounded to the nearest full percent) in Israel in 1960 through 1978:

Year	*Inflation rate*
1960	3%
1961	9
1962	10
1963	5
1964	4
1965	7
1966	8
1967	0
1968	2
1969	4
1970	10%
1971	13
1972	12
1973	26
1974	56
1975	24
1976	38
1977	42
1978	48

By the last quarter of 1978, inflation was at an annualized rate of 82 percent.

In 1979, the rate dropped in the first quarter, but then accelerated throughout the remainder of the year:

	First quarter	*Second quarter*	*Third quarter*	*Fourth quarter*
Inflation rate (annualized)	66%	93%	133%	168%

The overall inflation rate was 111.3 percent in 1979 (December 1978 to November 1979). On December 30, 1979, the Governor of the Bank of Israel (Israel's central bank) stated publicly that inflation in 1980 was not likely to drop below 100 percent.[10] In March 1979, the Government of Israel had made the slowing of the pace of inflation the immediate target of its economic policies for 1979; in the past, the Government had had some success in bringing inflation under control, such as in the years 1967 through 1969 and 1975.

The linkage of financial instruments—to the consumer price index or to a foreign currency—has a long history in Israel. Since the 1930s, the wages of most Israeli workers have been at least partially indexed for inflation, even during periods when inflation rates were not high. Israeli Government bonds have been fully or partially indexed or linked since 1948. By 1979, virtually all credit affecting consumers, such as medium (2 to 3 years) and long-term (4 to 15 years) savings plans and mortgages, was linked either to the consumer price index or to a foreign currency. However, in 1979, the linkage of commercial credit was not so pervasive. The Government of Israel extended the majority of credit in Israel, and private sector lenders, such as banks, made short-term loans almost exclusively. Most of such private sector credit was unlinked because, under Israeli law, it was illegal to link a loan to the consumer price index or to the exchange rate if the debt was likely to be repaid in less than 24 months. The interest rate on linked bank credit did not exceed 7.5 percent. The following chart shows the distribution of unlinked bank credit by interest rate in 1979:

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[10] As it turned out, the inflation rate in 1980 was 132.9 percent.

Stated interest rate	*Percent of outstanding credit*
[11]Up to 40	9.4
44-48	0.5
48-52	1.0
52-56	0.7
56-60	2.8
60-64	0.5
64-68	8.3
68-72	4.4
Above 72	72.4
Total	100.0

Interest rates on short-term unlinked debt increased throughout 1979, as exemplified by the rise in interest rates on bank overdraft accounts (a common way of receiving short-term credit):

1979			
First quarter	*Second quarter*	*Third quarter*	*Fourth quarter*
63%	69%	93%	132%

Market interest rates for unlinked long-term loans in 1979 are unavailable because the Government extended most of such credit at subsidized rates. Prior to May 29, 1979, Government commercial loans were not linked. From January to May 1979, such loans (with the exception of loans made by the Office of Chief Scientist of the Ministry of Industry, Commerce and Tourism) bore interest of 22 to 32 percent, depending on the nature of the enterprise and the location in the country where the money was to be spent. On May 29, 1979, the Government changed its loan policy in view of the high level of inflation and the uncertainty with regard to the future pace of inflation. All long-term loans (except Chief Scientist loans) applied for after May 29, 1979, were fully linked either to the consumer price index or to the U.S. dollar. If linked to the consumer price index, the loan had an interest rate of from 0.5 to 1.5 percent; if linked to the dollar, the loan had an interest rate of from 6.0 to 7.5 percent.

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[11] The exhibit from which this chart is taken reads "up to 40"; it should probably read "up to 44."

The terms of the partnerships' periodic payments liabilities under the development agreements were modeled on the terms of loans made by the Office of Chief Scientist. The Chief Scientist made subsidized long-term loans for research and development to encourage foreign investment in research and manufacturing in Israel. To qualify for the loan, the foreign investor, as a partner in an Israeli partnership, had to match the amount of the pound (later, shekel) loan with an equivalent amount in U.S. dollars, at current exchange rates. The loan principal matured in 12 years, was not linked, and bore interest of 5 or 6 percent in 1979.[12] If the project was successfully developed prior to the maturity date, 25 percent of the "net profit" (a defined term) was payable to the Government in reduction of the principal and interest on the loan.

Under the income tax laws of Israel in 1979, accrual method creditors, but not cash method creditors, were required to recognize "linkage differentials" as currently taxable income; that is, the law required that *linked* financial assets (and liabilities) be adjusted periodically to current values, making linkage differentials an item of taxable income (or expense) for the period.

In October 1977, the Israeli Government implemented a "New Economic Policy." Two elements of this policy were (1) a devaluation of the Israeli pound from 10 pounds to $1 U.S. to 15 pounds to $1, and (2) a liberalization of foreign exchange rates by allowing the value of the Israeli currency to float freely as against other currencies. The latter policy suggested that, in the long run, the pound (shekel)-dollar exchange rate would rise by approximately the relative inflation in Israel as compared to the inflation in the United States.[13] Factors other than the relative rate of inflation also affect exchange rates, and in subsequent years, the foreign exchange market was not perfectly free because the

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[12] Since 1982, loans made by the Office of Chief Scientist have been linked.

[13] For example, if the inflation rate was 111 percent in Israel and 10 percent in the United States, then the exchange rate of the Israeli pound versus the dollar should rise by about 92 percent, calculated as follows:

$$\text{Devaluation rate} = \frac{1 + \text{inflation rate in Israel}}{1 + \text{inflation rate in U.S.}} - 1$$

in our example,

$$91.8\% = \frac{1 + 1.11}{1 + .1} - 1$$

Israeli Government implemented new controls on foreign exchange dealings. However, there was some concurrence between the rate of Israeli inflation and the rate of Israeli currency depreciation against the dollar in the years following the implementation of the liberalized exchange policy:[14]

Year	*Inflation rate*	*Currency depreciation rate*
1977	42%	76%
1978	48	24
1979	111	86
1980	133	118
1981	101	106
1982	131	115
1983	191	220

On December 19, 1979, the exchange rate was 33.83 pounds to $1 U.S. (or 3.38 shekels to $1). On December 31, 1979, the exchange rate was 34.02 pounds to $1 (or 3.40 shekels to $1). By May 2, 1984, the most recent date for which an exchange rate is available in the record, the exchange rate had risen to approximately 175 shekels to $1. Thus, during the period from December 1979 to May 1984, the Israeli currency was devalued against the dollar by about 5,200 percent.[15]

The private placement memorandums of Dispoard and Labless referred to the effect of the continuous devaluation of the Israeli pound on the liability for periodic payments several times. For example, the section of the memorandums that dealt with the tax consequences of an investment in the partnerships stated, in part:

> (i) * * * Therefore, their [the limited partners'] basis should be equal to the amount of their cash contributed to the Venture plus their share of the Venture's liabilities resulting from the Development Agreement for which they are personally liable. However, in the event the Israeli Pound continues to decline in value with respect to the U.S. dollar, the amount of this obligation at the end of each subsequent year, converted into U.S. dollars, may also decline. Although such decline should not affect the Limited Partners' basis, since the Venture anticipates accounting for all items at their historical costs, the Service may treat such a decline in

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[14] All figures are rounded to the nearest full percent.

[15] The rate of currency depreciation for any period is calculated in the following manner:

$$\frac{\text{Beginning Exchange Rate} - \text{Ending Exchange Rate}}{\text{Beginning Exchange Rate}} = \begin{matrix}\text{Percentage}\\ \text{Depreciation}\end{matrix}$$

obligation as a distribution of cash from the Venture thereby resulting in taxable income to the Limited Partners.

(j) Although the Venture has an unconditional obligation to pay the entire contractual obligation, in the event the product being developed on its behalf is not successfully developed, manufactured and marketed, the date of such required repayment is considerably in the future, subject to reduction, in terms of United States dollars, in the event the Israeli Pound decreases in value with respect to the dollar. Due to the substantial likelihood that the amount of such obligation stated in terms of U.S. dollars may be substantially reduced through such devaluation, the Internal Revenue Service may contend that the Limited Partners are not "at risk" with respect to all or a portion of his [sic] contractual obligation for which they are personally liable.

The 1979 Federal tax returns of Dispoard and Labless were filed on a calendar year basis and were prepared by use of the accrual method of accounting. Dispoard reported an ordinary loss of $472,782, which consisted of the following claimed expenses (the partnership reported no income):

Direct developmental expenses	$459,262
Financial advisory fees	11,242
Partnership fees	1,465
Miscellaneous	79
Interest and exchange rate differences	734
Total	472,782

The development expense of $459,262 consisted of cash payments made in 1979 ($117,613) plus the dollar value of Dispoard's I£11,558,000 first stage periodic payments liability to DMC at the December 19, 1979, exchange rate of 33.83 pounds to the dollar ($341,649). Of the $117,613 of cash deducted as a development expense, $20,000 was eventually remitted to TEC, and from TEC to the law firm of Shefsky, Saitlin & Froelich as a legal fee. Such fee consisted of syndication fees of $10,000 and organizational expenses, as defined in section 709(b)(2), of $10,000.

On its return for 1979, Labless reported an ordinary loss of $963,538, which was calculated as follows:

Interest income	$258
Expenses:	
Direct developmental	947,517
Accounting and advisory	13,941
Interest	2,338
Total expenses	963,796
Ordinary loss	(963,538)

The parties have stipulated that the developmental expense of $947,517 consisted of cash payments ($227,352) plus the dollar value of three Israeli pound liabilities, totaling I£24,500,000, assigned to Labless by Achad, Shtayim, and Shalosh, at the December 31, 1979, exchange rate of 34.02 pounds to the dollar ($720,165).[16] Of the cash payments deducted as a developmental expense, $50,000 was eventually remitted to Shefsky, Saitlin & Froelich as a legal fee. Such fee consisted of syndication fees of $25,000 and organizational expenses, as defined in section 709(b)(2), of $25,000.

Achad, Shtayim, and Shalosh filed partnership returns for 1979, using the accrual method of accounting. Each partnership reported an ordinary loss for the year, which consisted of the partnership's distributive share of Labless' loss and certain additional deductions (each partnership had no income), as follows:

	Achad	*Shtayim*	*Shalosh*
Distributive share of Labless' loss	$356,509	$308,332	$298,697
Partnership fees	1,165	1,014	970
Miscellaneous	27	24	23
Inland travel expense	...	6	...
Total	357,701	309,376	299,690

On their Federal income tax returns for 1979, Mr. Hrabosky claimed a loss deduction of $101,567 attributable to the operation of Dispoard, and Mr. Levin claimed a loss deduction of $37,916 attributable to the operations of Labless and Achad. In his notices of deficiency, the Commissioner has disallowed such deductions in full.

OPINION

The only issues for decision are whether the partnerships, Dispoard and Labless, are entitled to the deductions claimed by them for research and experimental expenses and for interest expenses. The petitioners have made no argument with respect to the other deductions claimed by Dispoard, Labless, and Achad and, therefore, are deemed to have conceded their nondeductibility. Rule 142(a), Tax Court Rules of Practice and Procedure. Furthermore, they have advanced no argument with respect to those amounts deducted by Dispoard and Labless as development expenses but which actually consisted of syndication fees and organizational expenses. It is settled that syndication fees are not deductible, either as expenses or through amortization (sec. 709(a); *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985)), and any payments by the partnerships for organizational expenses must be capitalized and, if elected, amortized in accordance with section 709(b). Since the partnerships have made no such election, the payments for organizational expenses are not amortizable. *Landry v. Commissioner*, 86 T.C. 1284 (1986).

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[16] It is not clear from the record what amounts were included in the Labless limited partnerships' liabilities, totaling I£24,500,000. Under the labeler and thermoformer development agreements, Labless owed DMC first stage periodic payments totaling only I£24,204,000. See text p. 708 *supra*.

Section 174(a)(1) provides, as a general rule, that a taxpayer may elect to "treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account." Expenditures so treated are deductible in the taxable year in which paid or incurred. Section 1.174-2(a)(2) of the regulations states that the provisions of section 174(a)(1) "apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor)."

The Commissioner maintains that Dispoard and Labless are not entitled to deductions for research and experimental expenses because (among other reasons[17]) they did not pay or incur such expenses "in connection with" any trade or business within the meaning of section 174. He contends that the partnerships were precluded by contractual arrangements and by design from ever actively engaging in trades or businesses. The petitioners acknowledge that

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[17] The other grounds asserted by the Commissioner on brief for disallowing all or a part of the claimed research and experimental deductions (or the losses arising therefrom) are (1) that the research or experimentation was not carried on "in * * * [the partnerships'] behalf" within the meaning of sec. 1.174-2(a)(2), Income Tax Regs., (2) that the petitioners were not "at risk" within the meaning of sec. 465 for the development fees denominated as periodic payments, and (3) that the partnerships were activities "not engaged in for profit" within the meaning of sec. 183.

Dispoard and Labless were not "carrying on" trades or businesses in 1979, but they maintain that the partnerships were conducting research and development activities "in connection with" businesses which would or might be carried on in the future.

In *Snow v. Commissioner*, 416 U.S. 500 (1974), revg. 482 F.2d 1029 (6th Cir. 1973), affg. 58 T.C. 585 (1972), the Supreme Court held that use of the phrase "in connection with * * * [a taxpayer's] trade or business" in section 174 was intended to dilute some of the conceptions of "ordinary and necessary" business expenses that had been suggested for section 162(a) and for other sections of the Code. Specifically, the Court disclaimed application to section 174 of the test advanced by Justice Frankfurter in a concurring opinion in *Deputy v. du Pont*, 308 U.S. 488, 499 (1940), wherein he maintained that carrying on any trade or business (for purposes of the predecessor of section 162) "involves holding one's self out to others as engaged in the selling of goods or services." The Court concluded in *Snow* that a trade or business test under section 174 which depended on the existence of production or sales of the invention "would defeat the congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market." 416 U.S. at 504. In so concluding, the Court overturned the lower courts in *Snow* and overruled earlier cases, which had held that research expenditures by a taxpayer not currently engaged in a trade or business were nondeductible, pre-operating expenses. See, e.g., *Snow v. Commissioner*, 58 T.C. at 594-596, affd. 482 F.2d at 1029, 1032, revd. 416 U.S. at 500; *Koons v. Commissioner*, 35 T.C. 1092 (1961).

Although *Snow* established that a taxpayer need not be currently carrying on a trade or business to obtain a deduction for research expenses,

> it did not eliminate the "trade or business" requirement of section 174 altogether. For section 174 to apply, the taxpayer must still be engaged in a trade or business *at some time*, and we must still determine, through an examination of the facts of each case, whether the taxpayer's activities in connection with a product are sufficiently substantial and regular to constitute a trade or business for purposes of such

section. * * * [*Green v. Commissioner*, 83 T.C. 667, 686-687 (1984). Emphasis in original; fn. ref. omitted.][18]

In *Green v. Commissioner*, *supra*, we held that a limited partnership, LaSala, that financed the research and development of four inventions but retained no control over the manufacturing or marketing of such inventions was not conducting research "in connection with" a trade or business for purposes of section 174. LaSala was organized to acquire and to invest in the development of the four inventions alone, in return for a royalty interest in the revenues derived from their commercial exploitation. Immediately after acquiring the inventions, LaSala contracted with NPDC, an unrelated party, to develop the inventions, and it granted NPDC the exclusive, worldwide right to manufacture, use, and sell the developed inventions for their patentable lives. After entering into such agreements with NPDC, LaSala was incapable of carrying on a trade or business with respect to the inventions; its activities could be, and were, purely ministerial. We concluded that LaSala "functioned only as a vehicle for injecting risk capital into the development and commercialization of the four inventions. Its activities never surpassed those of an investor. It was not the up-and-coming *business* which section 174 is intended to promote." 83 T.C. at 687; emphasis in original.

We need not, and do not, decide whether Mr. Wyslotsky, TEC, or any of the persons (other than the partnerships) involved in the transactions described herein was engaged in research or experimentation within the meaning of section 174; we must decide only whether the partnerships were engaged, at any time, in a trade or business in connection with which funds were expended for research and experimentation within the meaning of section 174. A careful review of the contracts executed by Dispoard and Labless and the actual activities of the partnerships convinces us that, like the limited partnership in *Green*, they neither intended nor were capable of ever engaging in trades or businesses. By design, each partnership's role was restricted to that of a passive investor. TEC needed funds to develop the new packaging machinery, or "systems," that it wished to add to its product line. Through the "off-balance-sheet" financing technique suggested by Mr. Shefsky, TEC's co-owner and an attorney-accountant, TEC obtained such financing, yet insured that it retained effective control over the development, manufacture, use, and marketing of the machinery for its probable commercial life.

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[18] See also *Spellman v. Commissioner*, T.C. Memo. 1986-403; *Hoerrner v. Commissioner*, T.C. Memo. 1985-347; *Shaller v. Commissioner*, T.C. Memo. 1984-584, on appeal (4th Cir., June 25, 1985); *Lahr v. Commissioner*, T.C. Memo. 1984-472, affd. sub nom. *Independent Electric Supply, Inc. v. Commissioner*, 781 F.2d 724 (9th Cir. 1986); *Kilroy v. Commissioner*, T.C. Memo. 1980-489.

Dispoard and Labless were organized in December 1979. In that same month, they entered into the development, manufacturing, and marketing agreements. All of the agreements were effective immediately. Under the development agreements, the partnerships disbursed virtually all of their capital to DMC to pay for the development of the packaging systems by TEC, TEC Packaging, and Israeli subcontractors. The partnerships had no power under the development agreements to direct the research and development, and although their general partner, Ms. Ben-Gershon, once accompanied Mr. Wyslotsky when a contract with an Israeli subcontractor was negotiated, the record reveals that Mr. Wyslotsky and TEC controlled the research and the disposition of the development funds. Under the manufacturing and marketing agreements, the partnerships granted TEC Packaging the exclusive right to manufacture, use, and market the packaging systems. The terms of both agreements exceeded the patentable lives of the systems: the manufacturing agreements were effective for 48 years, and the marketing agreements were effective for 29 years. In *Green v. Commissioner, supra*, we held that a similar grant, for consideration, of the exclusive right to manufacture, use, and sell an invention for the duration of the patent term constitutes a sale of the grantor's substantial rights in the invention. 83 T.C. at 679-680; see also *Waterman v. Mackenzie*, 138 U.S. 252 (1891); *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958); *Massey v. United States*, 226 F.2d 724 (7th Cir. 1955); *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955). However, we need not decide in the present case whether the combined result of the manufacturing and marketing agreements was to effect sales of the packaging machinery inventions because, even if the agreements granted only licenses, they deprived the partnerships of control over the manufacture, use, and sale of the developed machines for virtually the entire lives of the partnerships—the partnerships are to terminate in the year 2009.

Like the partnership in *Green*, Dispoard and Lablesss engaged in purely ministerial activities after executing the development, manufacturing, and marketing agreements. They maintained bank accounts, paid development, legal, and accounting fees, and filed tax returns. Labless also distributed the royalty payment received from the sale of one labeler. However, contrary to the petitioners' assertions on brief, there is no evidence that the partnerships, through Ms. Ben-Gershon, in any way actually directed the development or marketing of the packaging systems. For example, the petitioners claim that when Allstate gained control of TEC in 1983, the partnerships "negotiated a termination of TEC's involvement in the research and development, demanding and obtaining from DMC a reassignment of the subcontracted matters to other companies with which Mr. Wyslotsky had become affiliated." In fact, the assignments from TEC to Mr. Wyslotsky's new corporation were a part of the agreement whereby Allstate and Hambro took control of TEC and forced Mr. Wyslotsky to resign from the corporation. As a part of the deal, Mr. Wyslotsky's new firm was assigned all rights to the manufacturing, marketing, and development contracts for the bacon board dispenser and the thermoformer (but not the labeler). There is absolutely no evidence that the partnerships, Ms. Ben-Gershon, or DMC in any way initiated or negotiated such assignments. For the same reason, the petitioners' contention that the partnerships caused the manufacturing agreements to be assigned to Mr. Wyslotsky's new firm pursuant to the agreements' provision for replacement of TEC Packaging if it became uneconomic for it to produce the machinery is unfounded. Finally, there is no evidence that the partnerships took part in setting the prices and terms of sale of the machinery, or were ever called upon to finance the manufacturing costs of machines which were sold before final payment was received from a customer. Interestingly, despite the petitioners' strained attempts to portray business-like activities of the partnerships, they offered no substantial explanation for Labless' lateness in pursuing the money to which it was entitled from TEC's sales of the second labeler and the three thermoformers: the petitioners assert that legal action would have been fruitless because TEC, by that time, was insolvent, but TEC's insolvency has not been proven, and in 1983, Allstate invested more money in TEC and, eventually, sold TEC to an established company.

In short, we are thoroughly persuaded that when Dispoard and Labless were organized in 1979, they never intended to engage in trades or businesses at any time in the future, and this conclusion is supported by the limited nature of their activities in the years following. The role of the partnerships was similar to that of a shareholder who contributes money to a corporation. Even though the corporation may engage in research or experimentation in connection with its trade or business, the shareholder is not in the trade or business and is not entitled to a deduction under section 174. See *Deputy v. du Pont, supra.* The partnerships, like the shareholders, were mere investors. Therefore, because they did not incur research and experimental expenses "in connection with" trades or businesses, Dispoard and Labless are not entitled to deductions for such expenses in 1979. We are merely holding that the claimed expenses are not deductible under section 174; we do not have before us the issue of what are the other tax consequences of any amounts actually spent by the partnerships for research and experimentation.

The second issue for decision is whether Dispoard and Labless are entitled to deductions for the accrued interest on their first-stage periodic payments obligations to DMC. The Commissioner maintains that the partnerships' liabilities for the periodic payments were not genuine debts because they lacked economic substance. The petitioners maintain that the liabilities did constitute genuine, recourse debts and that the terms of such liabilities were dictated by business considerations.

Section 163(a) allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." However, it is well established that section 163(a) does not permit the deduction of interest arising from loan arrangements that serve no "purpose, substance, or utility apart from their anticipated tax consequences." *Goldstein v. Commissioner,* 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965); see *Knetsch v. United States*, 364 U.S. 361 (1960); *Tolwinsky v. Commissioner*, 86 T.C. 929 (1986); *Julien v. Commissioner*, 82 T.C. 492 (1984); *Karme v. Commissioner*, 73 T.C. 1163 (1980), affd. 673 F.2d 1062 (9th Cir. 1982). In the present case, the interest deductions arise from the partnerships' deferred liabilities for development fees, which were incurred on December 19, 1979. These recourse deferred liabilities, or periodic payments, were stated in Israeli pounds, bore interest at the rate of 10 percent per annum in 1979, 1980, and 1981, and 8 percent thereafter, and were payable (with the accrued interest thereon) 50 percent by January 31, 1994, and 50 percent by January 15, 1995, unless sooner paid from revenues generated by sales of the systems. For the reasons set forth hereafter, we conclude that the periodic payments liabilities served no purpose beyond generating tax deductions under sections 174 and 163.

At the outset, we observe that the question of the proper tax accounting treatment of a genuine debt stated in a foreign currency, such as the Israeli pound (or shekel),[19] is distinct from the question of whether the obligation itself is a genuine debt. Only if the debt is found to be genuine does the question of its proper accounting treatment arise.

We have gleaned a number of facts regarding Israeli capital markets, inflation rates, and currency exchange rates from the experts' reports and testimony presented by both parties. These facts (set forth more fully in our findings of facts) establish that, other than the Office of Chief Scientist of Israel's Ministry of Industry, Commerce and Tourism, Israeli creditors, including the Government, did not extend credit in December 1979 on the terms granted to Dispoard and Labless under the development agreement. Private sector lenders made short-term loans almost exclusively. Such loans were not linked because

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[19] It appears to be the rule that an obligation stated in a foreign currency is reported for Federal tax purposes in U.S. dollars at the rate of exchange in effect on the date incurred. If, because of a subsequent decline in the value of the foreign currency, the debt is satisfied at a lower dollar cost than originally reported, the taxpayer recognizes a gain at that time from a separate transaction—the speculation in foreign currency. *Willard Helburn, Inc. v. Commissioner*, 214 F.2d 815 (1st Cir. 1954), affg. 20 T.C. 740 (1953); *America-Southeast Asia Co. v. Commissioner*, 26 T.C. 198 (1956); Rev. Rul. 75-106, 1975-1 C.B. 31; R. Rhoades & M. Langer, 2 Income Taxation of Foreign Related Transactions 6-24 to 6-25 (1985); see also *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983), affd. 749 F.2d 369 (6th Cir. 1984).

Israeli law forbade the linkage of short-term (less than 24 months) debt, but such debt bore much higher rates of interest than loans linked to either the Israeli consumer price index or a foreign currency, such as the dollar. In 1979, over 72 percent of the unlinked credit extended by Israeli banks bore interest at rates exceeding 72 percent. Most long-term credit (over 24 months) was extended by the Israeli Government and at subsidized interest rates. By June 1979, all new long-term loans made by the Government, except Chief Scientist loans, were fully linked either to the consumer price index or to the dollar, and such loans bore interest ranging from 0.5 to 1.5 percent if linked to the consumer price index or from 6.0 to 7.5 percent if linked to the dollar. Prior to June 1979, the Government loans were not fully linked but bore higher rates of interest (22 to 32 percent). The Government began linking its loans because of Israel's high rate of inflation in 1979 and the continuing uncertainty regarding future rates of inflation.

Only the Chief Scientist made loans on terms like those extended to the partnerships by DMC. The petitioners contend that because the Chief Scientist's loans were most like the partnerships' periodic payments liabilities, they are the "best comparables" and support the conclusion that the terms of the partnerships' liabilities were not unusual in the context of Israeli research and development projects and, therefore, were "justified by the commercial customs of the time and place." But this argument merely begs the question, which is "would a business person have extended credit in Israel in December 1979 on such terms?" That the Israeli Government extended such credit through its dollar "matching" loans from the Chief Scientist was attributable to its desire to attract foreign exchange and foreign investment in research and development in Israel. Those objectives are public, not business, concerns. That private sector creditors and the Government, when it made long-term loans to Israelis, did not extend credit on such terms reveals that the partnerships' liabilities were unique.

The petitioners advance two business reasons that allegedly motivated the use of unlinked debt. First, they maintain that if the devaluation of the pound continued, an unlinked debt gave DMC and TEC Packaging an incentive to complete development of the systems quickly: the longer development took, the fewer dollars would be received by them as periodic payments under the development and consulting agreements. Initially, we observe that this purpose cannot have substantially motivated the use of unlinked debt if, as the petitioners also allege, the parties to the contracts did not expect the value of the pound to continue falling after 1979. But more importantly, any incentive for prompt completion furnished by unlinked debt was superfluous. Under the consulting agreements, DMC was to pay 95 percent of the periodic payments to TEC Packaging, which, through Mr. Wyslotsky and TEC, would actually control the development of the systems. TEC Packaging had an independent incentive to complete quickly development of the systems in the manufacturing and marketing fees that it would receive. In fact, its marketing fees were to increase when it reached each system's "marketing achievement level."[20] The marketing achievement levels were roughly equivalent to the sales needed to extinguish the periodic payments liabilities. Of course, even with its increased marketing fee percentage, TEC Packaging's overall percentage interest in the systems' gross revenues would decline due to the termination of the periodic payments,[21] but its receipts in absolute dollars would always rise as sales rose. Thus, TEC Packaging and TEC had an incentive to develop the systems as expeditiously as possible, regardless of the nonlinkage of the periodic payments.

The petitioners also contend that Israeli income tax laws compelled, or at least supported, the use of nonlinked debt. They maintain that DMC insisted on unlinked debt because, as an accrual method taxpayer, it would have had to recognize each year as income the yearly increase in the value of the debts created by a linkage arrangement. Conceivably, if few or no periodic payments were made until the entire balance of the debts became due in 1995 (because sales were minimal or nonexistent), then DMC actually could be better off economically if the debts were unlinked: it would not have to pay income tax in the interim on the linkage differentials. The Commissioner argues that there is no proof that DMC was required to adopt the accrual method of accounting, but in any event, the petitioners' argument overlooks the fact that DMC apparently could have accrued an offsetting tax deduction for 95 percent of the linkage differentials because it was obligated to pay TEC Packaging 95 percent of the periodic payments. TEC Packaging used the cash method of accounting and, therefore, would not have had to recognize currently the linkage income. The petitioners' argument disregards the fact that if the systems were quickly and successfully marketed, linked debts would have provided a greater return to DMC and TEC Packaging, even though taxes were payable on linkage income. Since TEC Packaging was to receive almost all of the periodic payments and since it used the cash method, there is no apparent reason why such liabilities were unlinked unless it was intended that the partnerships never pay the dollar values originally ascribed to them.

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[20] Upon achievement of the marketing achievement levels, TEC Packaging's marketing fee percentage was to increase to 27 percent for the bacon board dispenser and the labeler and to 25 percent for the thermoformer.

[21] Prior to reaching the marketing achievement levels, TEC Packaging's total percentage interest in the gross revenues of the systems (via its 95-percent share of the periodic payments percentage, its manufacturing fee percentage, and its marketing fee percentage) was 78.95 percent for the bacon board dispenser, 83 20 percent for the labeler, and 84.25 percent for the thermoformer. After it reached the marketing achievement levels and the partnerships' periodic payments liabilities were satisfied TEC Packaging's total percentage interest in the gross revenues was 71 percent for the bacon board dispenser and 80 percent for the labeler and the thermoformer.

On this record, we are altogether convinced that the periodic payments liabilities were incurred solely for the tax benefits that they were expected to generate. They furnished the leverage needed to create a "tax shelter" for the investors in these research and development projects. According to Mr. Wyslotsky, TEC expected that the cash invested by Dispoard and Labless would be sufficient to cover the projected development costs of the systems, including a small margin for cost overruns; the periodic payments were to be the "profit" on the development. It is striking that the partnerships would agree to pay development stage "profits" of almost three times the expected development costs if they truly believed that the profits would not decline due to devaluation of the Israeli currency. In fact, the private placement memorandums of Dispoard and Labless reveal that the promoters expected continuing and substantial currency devaluation, which would substantially reduce (if not almost eliminate) the dollar amounts that the partnerships and the limited partners might have to pay when the debts came due 14 years later. The petitioners' own expert witness testified that, in mid-1979, one could have expected the Israeli inflation rate to be as high as 40 percent per year over the intervening period. Although we think his estimate conservative, if one assumes that the inflation rates are reflected in an equivalent decline in the value of a currency (which actually occurred), then for every $1,000 deducted in 1979 as a development fee expense, the partnerships would have to pay only $8.99 in 14 years.[22] If the rate of currency devaluation was greater than 40 percent, the dollar amounts owed would have been negligible.

The petitioners argue that the tax savings arising from the use of a linked debt actually would have been greater than those derived from the unlinked debt (because the partnerships will have to recognize foreign currency income in 1994 (see note 19 *supra*) and, consequently, tax savings could not have motivated the use of the unlinked debt. This argument ignores the fact that a linked debt would have had economic value to the creditors DMC and TEC Packaging, whereas the unlinked debt had little or none. Moreover, while the unlinked debts might furnish somewhat lower tax benefits than would be derived from linked, recourse debts,

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[22] If "d" represents the annual rate of Israeli currency depreciation relative to the U.S. dollar, then at the end of "n" years, 1/(1 + d)n dollars will be needed to buy 1 Israeli pound. The following formula yields the present value of a $1,000 obligation stated in pounds, if the obligations run from December 1979 to January 1994 and carries a 10-percent interest rate through 1982 and 8 percent thereafter:

$$\text{Present value} = \frac{\$1{,}000\,[(1.1)^3\,(1.08)^{11}]}{[(1+d)^{14}\,(1+i)^{14}]}$$

In this formula, the term $(1 + i)^{14}$ contains "i", the discount rate, which brings future value back to present value. If the interest rate on the obligation (i.e., 10 percent through 1982, 8 percent thereafter), is assumed to be the appropriate discount rate, the interest term in the numerator and the discount rate in the denomination cancel each other, so that the simplified expression

$$\frac{\$1{,}000}{(1+d)^{14}}$$

represents the value of the principal of the debt in dollars in 14 years. Assuming an annual currency depreciation rate of 40 percent, $1,000 of Israeli pound debt at 1979 exchange rates could be satisfied with $8.99 in 1994, thus:

$$\frac{\$1{,}000}{(1+.40)^{14}} = \frac{\$1{,}000}{111.12} = 8.99$$

they also would require *substantially* lower out-of-pocket expenditures in 1994 (for income taxes and to satisfy the debts) by the investors. Because of the lower out-of-pocket costs, the overall economic benefit to the investors from this scheme of tax arbitrage was greater using unlinked debt. Thus, tax savings, not business considerations, did form the basis for the inclusion of the periodic payments liabilities in these transactions. Consequently, we hold that Dispoard and Labless are not entitled to the interest deductions that they claimed in 1979.

Because of our resolution of the above issues, we find it unnecessary to consider alternative contentions raised by the Commissioner in his notices of deficiency.

Decisions will be entered for the respondent.

JOE KELLY BUTLER, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 13069-79, 33799-84. Filed September 29, 1986.

Petitioner made a bulk sale of assets which included personal property and real property. The real property was encumbered by a mortgage that exceeded the basis of petitioner in the real property. The mortgage was assumed by the purchaser as part of the consideration. *Held*, for installment reporting purposes, the mortgage in excess of the aggregate basis of all the assets sold is a payment in the year of sale and the sale qualifies for the installment method of reporting.

Rudy M. Groom, *Andrew W. Miller*, and *Lawrence E. Naiser*, for the petitioner.
Janet R. Kluth, for the respondent.

OPINION

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax as follows:

Docket No.	*Year*	*Deficiency*
13069-79	1974	$459,559.02
	1975	41,505.09
33799-84	1977	77,067.77
	1978	1.039.95

After concessions, the sole issue remaining for decision is whether petitioner is entitled to use the installment method to report gain attributable to the sale of real property sold as part of a bulk sale of assets.

This case was submitted fully stipulated under Rule 122.[1] The stipulation of facts and stipulated exhibits are incorporated herein by this reference.

Joe Kelly Butler, Inc. (petitioner), was a Texas corporation during the years in issue. Petitioner's principal place of business was Houston, Texas, at the time of the filing of the petitions in this case. Petitioner filed its Federal income tax returns for the taxable years 1974, 1975, 1977, and 1978 with the Internal Revenue Service Center in Austin, Texas.

In 1947, petitioner acquired 15.73 acres of land in Harris County, Texas, for $14,676. Petitioner constructed improvements on the land during the years 1947 through 1973 at a cost of $166,918 and deducted depreciation during those years of $50,676.

On December 4, 1972, petitioner borrowed $875,000 from Great Commonwealth Life Insurance Co. of Dallas, Texas, and pledged the land as collateral. The proceeds of the loan were used by petitioner for working capital or to repay prior loans for which the land had been pledged as collateral.

On October 1, 1974, petitioner sold various assets, including the land, to Mitchell Energy Corp. (Mitchell) for a total consideration of $6,401,345. The consideration consisted of $246,900 in cash, a $5,357,538 promissory note, and the assumption of the promissory note encumbering the land. The principal balance remaining on the assumed note was $796,907.

The sales agreement provided:

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[1] Unless otherwise indicated, all Rule references are to the Rules of Practice and Procedure of this Court, and all section references are to the Internal Revenue Code of 1954 as amended and in effect for the relevant years.

THIS AGREEMENT dated the 17th day of September, 1974, between BUTLER DRILLING COMPANY[2] (hereinafter referred to as "Butler"), * * * and MITCHELL ENERGY CORPORATION, a Texas corporation, with offices at 3900 One Shell Plaza, Houston, Texas (hereinafter referred to as "Mitchell");

WITNESSETH:

Section 1.1. Subject to the remaining provisions of this Agreement, Butler, * * * agrees to sell and convey to Mitchell (or to such affiliated corporations of Mitchell as Mitchell may designate at the closing) and Mitchell agrees to purchase * * * the entire operating assets described * * * in Exhibit "A" which is attached hereto and incorporated herein for all purposes (which are herein called the "Properties"). * * *

Section 1.2. Subject to the remaining provisions of this Agreement, Mitchell agrees to pay the sums set forth below * * *:

(a) *Butler.* Mitchell hereby agrees to purchase the assets of Butler as set forth on Exhibit "A" for a total purchase price of $5,604,438, subject to adjustment in accordance with Sections 1.8 and 1.9 of this Agreement. Said consideration shall be payable as follows:

(i) Mitchell shall pay to Butler at closing the sum of $246,900 in cash (Mitchell's $75,000.00 payment deposited with the letter of intent dated August 2, 1974, shall be credited toward this payment); and

(ii) Mitchell shall deliver to Butler at the closing its promissory note payable to Butler in the total principal amount of $5,357,538 containing the provisions set forth in Section 1.5 of this Agreement and secured as set forth in Section 1.6 of this Agreement.

* * * * * * *

Section 1.4. The Mitchell affiliated corporation receiving title to the 15.73 acres of land described in Exhibit "D" will assume the outstanding balance at closing of that certain promissory note in the original principal sum of $875,000.00, dated December 4, 1972, executed by Butler Drilling Company and payable to the order of Great Commonwealth Life Insurance Company, Dallas, Texas, secured by a deed of trust covering said land; the balance of said promissory note at October 1, 1974, will be no more than $796,906.72.

The parties agree that the fair market value on September 17, 1974, of each category of property sold was as follows:

Land	$1,268,585
Building	478,322
Furniture and fixtures	72,000
Equipment	11,976
Drilling rigs	4,570,462
Total	6,401,345

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[2] Joe Kelly Butler, Inc., formerly conducted business under the name Butler Drilling Co.

The cost, expenses of sale, accumulated depreciation, and adjusted basis of each category of property sold was as follows:

	Cost	*Expenses of sale*	*Accumulated depreciation*	*Adjusted basis as of 10/1/74*
Land	$14,676	$46,450	0	$14,676
Building	166,918	9,764	$50,676	116,242
Furniture and fixtures	73,395	4,260	48,641	24,754
Equipment	26,904	708	24,214	2,690
Rigs	2,003,284	270,444	1,330,463	672,821
Total	2,285,177	[1]331,626	1,453,994	831,183

[1] The parties stipulated that total selling expenses were $331,666. The figures provided for each category of selling expenses total $331,626. This discrepancy is immaterial to the resolution of the issue before us.

Petitioner elected to report the gain on the sale of the assets to Mitchell using the installment method. In the year of sale, petitioner recognized $27,155 as income from the sale of the real property. It is unclear exactly how petitioner calculated this amount but it is presumably some percentage of the cash received. It is clear, however, that petitioner did not treat the amount of the mortgage assumed by Mitchell in excess of the basis of the real property as a payment in the year of sale. In subsequent years, petitioner increased the gross profit percentage to an amount in excess of 100 percent in order to recognize as income the excess of the mortgage assumed over the basis of the real property.

The Commissioner, in his statutory notices of deficiency, determined that the portion of gain attributable to the sale of the real property did not qualify for reporting under the installment method because more than 30 percent of the purchase price was received in the year of sale. The Commissioner calculated the payments received by petitioner in the year of sale with respect to the real property as follows:

Mortgage assumed	$796,907
Less: Adjusted basis	[1]187,132
Mortgage over adjusted basis	609,775
Cash received	41,851
Total payments	651,626
Total sale price	1,746,907

Percentage of sale price received in year of sale	37%

[1] Respondent conceded on brief that selling expenses are to be added to the adjusted basis of the property.

If the mortgage assumed is compared to the aggregate basis of all the assets sold, there is no mortgage in excess of basis and the percentage of the purchase price received in the year of sale does not exceed 30 percent.

The statutory provisions permitting the installment method of reporting income were enacted because when sales are made on the installment basis, application of the cash or accrual basis of reporting creates a hardship. Payment of the entire tax on the profit may be required in a single year, even though the seller receives little or none of the selling price at that time. If the entire gain is taxed in that year, the seller might well be faced with a substantial tax without having a sufficient portion of the sales proceeds available to pay the tax. The installment reporting privilege is designed to alleviate this potential hardship by spreading the tax over the periods in which sales proceeds are received. *Burnet v. S. & L. Bldg. Corp.*, 288 U.S. 406, 413 (1933). The underlying concept is that the tax should be paid "from the proceeds collected rather than be advanced by the taxpayer." *Prendergast v. Commissioner*, 22 B.T.A. 1259, 1262 (1931). As the Supreme Court stated in *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948):

> The installment basis of reporting was enacted, as shown by its history, to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. * * * [333 U.S. at 503.]

Section 453[3] provides, in part, that in the case of an installment sale, income need not be reported until payments are "actually received." The amount to be reported in any one year is the proportion of the installment payments received that year, that the gross profit bears to the total contract price. With respect to sales of real property or casual sales of personal property, installment reporting is not available where the amount of all payments received in the year of sale exceeds 30 percent of the selling price.[4]

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[3] During the taxable years in issue, sec. 453 provided as follows:

SEC. 453. INSTALLMENT METHOD.

(a) DEALERS IN PERSONAL PROPERTY.—

(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

* * * * * * *

Section 1.453-4(c), Income Tax Regs., provides that where encumbered property is either sold subject to an existing mortgage, or the mortgage is assumed by the purchaser, the amount of the mortgage is not taken into account for the purpose of determining the amount of payments received by the seller nor for the purpose of determining the contract price.[5] However, to the extent that the mortgage exceeds the seller's basis in the property, the excess is considered as a payment received in the year of sale and is included in the contract price. Sec. 1.453-4(c), Income Tax Regs.

Respondent has determined that petitioner is not entitled to use the installment method to report the gain attribut-

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(b) SALES OF REALTY AND CASUAL SALES OF PERSONALTY.—

(1) GENERAL RULE.—Income from—

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000, may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) LIMITATION.—Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

[4] The 30-percent limitation was eliminated by sec. 2(a) of the Installment Sales Revision Act of 1980, Pub. L. 96-471, 94 Stat. 2247.

[5] Sec. 1.453-4. Sale of real property involving deferred periodic payments.

(c) *Determination of "selling price"*. In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the "selling price"; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and sections 1.453-1 through 1.453-7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property. The term "payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

able to the real property sold as part of the bulk sale of assets to Mitchell. To reach this conclusion, respondent argues that the assets sold must be divided into classes and the gain analyzed by class. Respondent then contends that the mortgage assumed in excess of the basis of the mortgaged property (the real property) is a payment in the year of sale with respect to the real property. As a result, petitioner received more than 30 percent of the sales price of the real property in the year of sale.

Petitioner argues that because the mortgage assumed does not exceed the basis of all the assets sold, there is not a payment in the year of sale attributable to a mortgage in excess of basis. Petitioner then argues that, as a result, less than 30 percent of the sales price was received in the year of sale and the gain attributable to the real property is eligible for reporting under the installment method.

Section 453 does not address how a bulk sale of assets is to be analyzed. Respondent, however, argues that the segregation of assets is required because the statute sets out different rules for different classes of assets. Respondent reasons that personal property and real property must be examined separately because personal property is subject to a $1,000 minimum sales price limitation. Sec. 453(b)(1)(B). However, absent any special allocation, the relevant percentage of initial payments to selling price is the same whether total initial payments are compared to the gross price or the initial payment attributable to each component is compared to an allocable portion of the gross price. In other words, if personal property and real property are sold as part of a bulk sale of assets and less than 30 percent of the total sales price is received in the year of sale, then absent any special allocation, less than 30 percent of the sales price allocable to each component (personal property and real property) will be received in the year of sale. Accordingly, we are not persuaded by respondent's argument that the statute requires the segregation of personal property and real property sold as part of a bulk sale of assets.

An examination of the history and purpose of section 1.453-4(c), Income Tax Regs., reveals that it was not designed primarily to govern year-of-sale payments but was introduced for an entirely distinct technical purpose, and its effect on year-of-sale payments is merely an incidental by-product.

Prior to amendment in 1929, the predecessor of the current regulations under section 453 provided that:

> In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall not be considered as a part of the "initial payments" or of the "total contract price," but shall be included as part of the "purchase price," * * * [Regs. 69, art. 44 (1926).]

The rationale behind this early regulation was explained by the Supreme Court in *Burnet v. S. & L. Bldg. Corp.*, 288 U.S. 406 (1933). The installment method of reporting requires a portion of every payment made by the buyer to be taxed as gain to the seller. If the buyer assumes a mortgage or other liability of the seller, in all cases in which the regulation does not apply, recognition of gain is spread over not only the payments made by the buyer to the seller but also over payments made by the buyer to creditors of the seller. Thus, each time the buyer makes a payment to a creditor of the seller, the seller must report some income. This application of the installment method results from including liabilities assumed in the "contract price." *Burnet v. S. & L. Bldg. Corp., supra* at 412-414.

In order to eliminate the administrative inconvenience and practical difficulties of imposing and collecting a tax from the seller every time the buyer made a payment to the third-party mortgagee, the original version of Regs. 69, art. 44 (1926), defined "contract price" as not including the amount of an assumed mortgage. The regulation, therefore, has the effect of raising the gross profit percentage,[6] thus permitting recognition of all of the gain solely upon payments made directly to the seller. *Burnet v. S. & L. Bldg. Corp., supra* at 412-414.

The regulation was amended in 1929 to provide that mortgages assumed, to the extent they exceed the basis of the seller in the property, were to be included in both "contract price" and "initial payments." The amended regulation, which is in essence the same as the current regulation, represented a compromise between two conflicting policy considerations. In cases in which the property was sold subject to a mortgage that exceeded the basis of the property, the gross profit percentage calculated according to the regulation prior to amendment would be greater than 100 percent. In such a situation, the total gain on the transaction would be greater than the total direct payments ultimately to be received by the seller. If the total gain is to be recognized and taxed only as payments are received by the seller, the gross profit percentage must be greater than 100 percent.

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[6] $\text{Gross profit percentage} = \frac{\text{Gross profit}}{\text{Contract price}}$

Rather than impose a tax on a gain of greater than 100 percent of payments received, the regulation requires the "contract price" to include the excess of the mortgages assumed over the seller's basis, thus producing a gross profit percentage of 100. However, if some portion of the mortgage assumed is to be included in the "contract price," then there would still exist the administrative problem of taxing gain to the seller as payments are made by the buyer to the third-party mortgagee. The regulation eliminates this problem by including the mortgage assumed, to the extent it is included in the "contract price," in the "initial payments." This triggers, in the year of sale, recognition of the entire amount of gain in excess of cash to be ultimately received. By recognizing gain in the year of sale to the extent necessary, the administrative problem of recognition of gain upon payments by the buyer to the mortgagee is eliminated, and the gross profit percentage applicable to cash eventually received by the seller is equal to 100 percent.

The inclusion of the mortgage in excess of basis as a payment received in the year of sale is intended to address a particular situation. Hence, we view the underlying purpose of the regulation to suggest that it should be read narrowly and applied sparingly. Therefore, we will not apply the regulation in a manner that results in the unintended side effect of increasing year-of-sale payments and thereby disqualifying a transaction under the 30-percent test.

We have also examined the cases cited by respondent as authority for the proposition that a bulk sale of assets must be treated for installment sale purposes as a sale of the separate classes of assets. *Bostedt v. Commissioner*, 70 T.C. 487 (1978); *Monaghan v. Commissioner*, 40 T.C. 680 (1963). Based upon our analysis, we conclude that these cases are distinguishable.

Monaghan v. Commissioner, *supra*, involved the sale of the assets of a liquor business. The sales agreement did not allocate prices to the assets sold, but provided a total purchase price for the business. An additional agreement was executed that stated the purchase price of the inventory. Respondent argued that the facts indicated a sale of the entire business and that the sale could not be fragmentized. We held that since the inventory was specifically excluded by the statute from the privilege of installment reporting, the proceeds attributable to the inventory were excluded from the 30-percent limitation test. *Monaghan v. Commissioner*, *supra* at 687. Since we only required segregation of the inventory, which is specifically excluded from the installment reporting provisions, this case does not support respondent's argument that a bulk sale of assets must be treated for installment sale purposes as a sale of the separate classes of assets.

In *Bostedt v. Commissioner*, *supra*, we dealt with the proper application of the installment method to report gain on the sale of a motel. The issue was whether a purchaser's payment of the seller's commission expenses as part of the bargained for exchange constituted payment in the year of sale. We held that it did and, as a result, the seller received more than 30 percent of the sales price in the year of sale and was not entitled to report the gain under the installment method. *Bostedt v. Commissioner*, *supra* at 492. The assets sold consisted of personal property, goodwill, real property, and improvements. The Court stated in a footnote that the personal property was sold at a loss and since section 453 is not applicable to property sold at a loss, the personal property was segregated from the remaining assets. *Bostedt v. Commissioner*, *supra* at 489 n. 2. However, in calculating the amount of the payment attributable to mortgages in excess of basis, the mortgages assumed were compared to the adjusted basis of all the remaining assets.[7] The mortgages in excess of basis plus the cash received in the year of sale allocable to the remaining assets were then compared to the sales price allocable to the remaining assets to determine if payments in the year of sale exceeded 30 percent of the selling price. We classified the various assets only to the extent of the personal property sold at a loss. Accordingly, this case does not stand for the general proposition that a bulk sale of assets must be treated for installment sale purposes as a sale of the separate classes of assets.

In addition, the cases holding that the sale of a going business operated as a proprietorship is to be considered a sale of the separate business assets for purposes of ascertaining whether profit results in capital gain or ordinary income are not persuasive. *Watson v. Commissioner*, 345 U.S. 544 (1953); *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). The installment provisions do not govern the characterization of gain. They are timing provisions that simply determine the taxable year in which income from an installment sale is to be recognized. The considerations present in allocating gain between capital gain and ordinary income are not controlling for purposes of determining when income is to be recognized.

On the stipulated record here we are presented with a factual situation in which petitioner sold various assets to Mitchell. There was one sales agreement covering all of the assets sold. The total consideration of $6,401,345 consisted of $246,900 in cash, a promissory note in the principal amount of $5,357,538, and an assumption of the promissory note of petitioner payable to Great Commonwealth Life Insurance Co. in the amount of $796,907. The sales agreement does not allocate the consideration to the various assets sold. The note assumed was merely a component of the total consideration. The sales agreement does not indicate that the note assumed was part of the consideration for the real property only. Therefore, we conclude that there is no reason to examine the real property separately and treat the mortgage assumed as consideration solely attributable to the real property. There is simply no warrant for such fragmentation.

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[7] The remaining assets consisted of land, improvements, and goodwill. The basis of the goodwill was zero, but the selling expenses attributable to the goodwill were included in the adjusted basis.

Our analysis would not be complete without an examination of the case law of the U.S. Court of Appeals for the Fifth Circuit (the court to which this decision is appealable). Of particular importance is *Irwin v. Commissioner*, 390 F.2d 91 (5th Cir. 1968), revg. and remanding 45 T.C. 544 (1966). While the holding of that case is not controlling and we are not applying our rule in *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971), the reasoning of the Fifth Circuit is instructive with regard to the resolution of the issue presently before us.

Irwin v. Commissioner, supra, dealt with the sale of an insurance business, operated as a partnership. The seller's adjusted basis in the assets was $349,189.86. The purchasers paid $81,539.64 in cash at closing and delivered promissory notes to the sellers in the amount of $390,000. No payments were made on the promissory notes in the year of sale. In addition, the purchasers assumed the partnership business liabilities of $271,186.95 consisting of insurance premium notes payable, accounts payable to insurance companies, payroll taxes, various automobile notes, and other accounts payable. No part of these liabilities was due purchasers. During the year of sale, the purchasers paid a total of $237,974.05 on these liabilities in the regular course of business. We concluded that the payment of these business liabilities by the purchasers was part of the payment received by the sellers in the year of sale within the meaning of section 453(b)(2)(A). As a result, the sellers received more than 30 percent of the selling price during the year of sale and were not entitled to report their gain from the sale on the installment basis. *Irwin v. Commissioner*, 45 T.C. at 554.

On appeal, the Fifth Circuit held that these current liabilities, although assumed and paid, were not payments in the year of sale. To reach its conclusion, the Fifth Circuit applied section 1.453-4(c), Income Tax Regs., to nonmortgage liabilities. *Irwin v. Commissioner*, 390 F.2d at 96. Since the liabilities assumed ($271,186.95) were not in excess of the basis of the assets sold ($349,189.86) no part of the liabilities, although assumed and paid, was includable as a payment in the year of sale.

The Fifth Circuit compared the liabilities to the basis of all the assets sold to determine if there was a payment in the year of sale attributable to liabilities in excess of basis. We do not think it would analyze the situation differently if, as in the instant case, there was a mortgage that is secured by a portion of the assets sold. This transaction involves a bulk sale of assets covered by one sales agreement and the note assumed was merely a component of the total consideration.

In footnote 2 of its opinion, the Court of Appeals commented upon fragmenting the sale as follows:

> Taxpayers assert an additional theory for reversal. They would fragment the sales price into payment for good will on the one hand and payment for assets on the other and thus avoid the thirty per cent stricture. The government contends that this theory was withdrawn in the Tax Court and thus not considered there. In the view we take of the case we might forego decision on this theory but we think it warrants the statement, aside from the procedural bar asserted by the government, cf. *Helvering v. Wood*, 1940, 309 U.S. 344, 348-349, 60 S.Ct. 551, 84 L.Ed. 796; *General Utilities & Operating Co. v. Helvering*, 1935, 296 U.S. 200, 206, 56 S.Ct. 185, 80 L.Ed. 154, that there is no warrant whatever for such fragmentation. There was one sale for one price and it would be exalting form over substance to sustain such a fragmentation approach. Cf. *Commissioner of Internal Revenue v. Court Holding Company*, 1945, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981; *Reef Corporation v. Commissioner of Internal Revenue*, 5 Cir., 1966, 368 F.2d 125, 130; *General Guaranty Mortgage Company v. Tomlinson*, 5 Cir., 1964, 335 F.2d 518, 520; *Hindes v. United States*, 5 Cir., 1964, 326 F.2d 150, 151. [*Irwin v. Commissioner*, 390 F.2d at 93 n. 2.]

Accordingly, it is our conclusion that the Fifth Circuit would compare the mortgage assumed to the basis of all the assets sold to determine if there was a payment in the year of sale attributable to a mortgage in excess of basis.

Therefore, we hold that, on the facts of this case, petitioner received a payment in the year of sale attributable to a mortgage assumed in excess of basis only to the extent that the mortgage assumed exceeds the basis of all the assets sold. Since the mortgage assumed was $796,907 and the basis of all the assets sold was $831,183, we conclude that there was no mortgage in excess of basis.

Accordingly, petitioner is entitled to report the gain attributable to the real property under the installment method.[8] Furthermore, as a result of our refusal to segregate the assets there will be a single gross profit percentage for the entire sale.

To reflect concessions and the foregoing,

Decisions will be entered under Rule 155.

FRATERNAL ORDER OF POLICE ILLINOIS STATE TROOPERS LODGE NO. 41, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 9035-81, 3944-83. Filed September 29, 1986.

Petitioner, an exempt organization under sec. 501(c)(8), I.R.C. 1954, published The Trooper magazine. In addition to articles relating primarily to the duties of police officers, The Trooper contained two types of business listings covering a wide range of professional, consumer, and leisure products and services. The first type, the business directory, classified and arranged the listers in the same manner as the yellow pages of a telephone directory. The second type, referred to as "large listings" contained the usual elements of advertisements such as blocking, illustrations, signatures, trademarks, and emblems. Respondent determined that petitioner's receipts from the listings constituted unrelated business taxable income. *Held*, the business listings constitute "advertising." *Held, further*, the publication of advertising constitutes a trade or business within the meaning of sec. 513 and, therefore, the receipts from the business listings are "unrelated business taxable income." *United States v. American College of Physicians*, 475 U.S. __ (1986). *Held, further*, the receipts from the listings publication are not royalties excluded from taxation by sec. 512.

John J. Vassan, *Patrick B. Mathis*, and *George E. Marifian*, for the petitioner.

Matthew J. Fritz, for the respondent.

SHIELDS, *Judge*: Respondent determined deficiencies in petitioner's income tax as follows:

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[8] In view of our resolution of the issue, we need not comment upon the other arguments of petitioner.

Year ended Sept. 30—	*Deficiency*
1976	$65,769.80
1977	83,174.05
1978	42,677.52
1979	47,620.63
1980	94,353.90

The issue for decision is whether the receipts of petitioner generated by certain listings in The Trooper magazine constitute income derived from an unrelated trade or business under section 511,[1] and if so, whether such receipts are excludable from unrelated business taxable income as royalties under section 512(b)(2).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by reference.

Petitioner the Fraternal Order of Police, Illinois State Troopers Lodge Number 41 (FOP), is a not-for-profit corporation organized under the laws of the State of Illinois and had its principal place of business in Springfield at the time it filed its petition. Petitioner is an exempt organization under section 501(c)(8). Its active members are regularly appointed and commissioned police officers in the Illinois Department of Law Enforcement or Troopers in the Illinois State Police. FOP's constitution and bylaws state that its purpose is to assist worthy members, their families, widows, and orphans.

In August 1975, FOP formed the Troopers Alliance (Alliance). Alliance had basically the same membership as FOP and was formed to carry out the specific goal of providing money for hospitalization and dental programs for members and their families.

In September 1975, Alliance entered into a solicitation and publishing agreement (agreement I) with Organization Services Corp. (OSC) for the publication of a magazine known as The Trooper. Under agreement I, Alliance was to receive 20 percent of the "gross advertising revenue actually collected" by OSC. Agreement I referred to parties solicited to place "listings" in the magazine as "advertisers" and to "listings" as "advertising." The solicitation program was referred to as the "ad solicitation program," the "advertising marketing program," and the "marketing of advertising." Agreement I also provided that OSC was to determine the "advertising rates * * * for local and national advertisers" and referred to the receipts to be derived from the contracts as "advertising revenue."

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[1] All section references are to the Internal Revenue Code of 1954 as amended, and in effect during the years in issue unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure unless otherwise indicated.

On December 20, 1975, Alliance assigned all of its right, title, and interest in agreement I to petitioner. On December 23, 1975, petitioner and OSC canceled agreement I and entered into a second solicitation and publishing agreement (agreement II). Agreement II was identical in all material respects to agreement I, except that under the new agreement petitioner was given greater control over the bank account into which the revenues were to be deposited. Petitioner's executive committee was then informed that Alliance had been disbanded and that its "ad solicitation program" would thereafter be conducted by petitioner. The committee was also advised that future proceeds from the program would be used to provide death benefits, legal assistance, scholarships, hardship assistance, and possibly dental insurance for FOP members and their families.

On December 24, 1978, petitioner and OSC entered into another publishing agreement (agreement III). Agreement III provided that OSC was to publish each issue of The Trooper within 10 weeks after having collected $150,000 in "advertising revenue." Agreement III also increased FOP's share of "gross advertising revenue actually collected" from 20 percent to 23 percent.

The Trooper is comparable in quality to most nationally published commercial magazines, and in content, is almost identical to Law and Order, an independent magazine published for policemen. Its editorials and articles are of particular interest to police officers and cover a wide range of professional, commercial, consumer, and leisure topics. The Trooper's circulation during the years in issue was approximately 2,000. Copies were distributed to FOP members and associate members, businesses and individuals having listings in The Trooper, Illinois legislators and other public officials, as well as other persons designated by petitioner from time to time. One of petitioner's officers served as executive editor of the magazine and petitioner had the right to censor text, editorials, and business listings, as well as to control any reprints.

The business listings in The Trooper were of two types, both of which covered a wide range of professional, commercial, consumer, and leisure goods or services. The first type of listing was the business directory which classified and arranged the listers in the same manner as the "yellow pages" of a telephone directory. The business directory was preceded by this statement:

> ON THE FOLLOWING PAGES, listed by category of service or product, are advertisers who support The Trooper magazine. Consider these fine companies when making purchases for yourself or your family.

The second type of listings were referred to as "large listings" and included such well-known companies or products as American Airlines, Michelob Beer, and Johnny Carson Clothes, as well as Midas Mufflers and Ryder Trucks. The Trooper had an "Advertisers' Index" which contained the name of the sponsor of each large listing and the page upon which its listing was located. Large listings contained the usual elements associated with advertisements such as blocking, illustrations, signatures, trademarks, and emblems. Many of the large listings contained well-known slogans used by the sponsors in their national advertising.

OSC employed an independent contractor to solicit listings for individuals and corporations. The contractor or one of his employees would contact a potential lister and, after a brief introduction, would inform the potential lister that FOP was putting together the next issue of The Trooper, the proceeds from which would be added to FOP's death fund and used to aid the families of policemen and troopers killed or injured in the line of duty. The potential lister would then be asked to sponsor a "nice listing" in the magazine. All solicitations were monitored by FOP members.

The rates for listings during the years in issue were as follows:

Large listings:

Size	Cost
Two pages	$1,200
Full page	665
2/3 page	525
1/2 page	415
1/3 page	345
1/4 page	285
1/6 page	195

Business directory listings:

Size	Cost
2 column inches	$100
1 column inch	75
3/4 column inch	50
4 lines	35
2 lines	25-30
1 line	15-20

Each sponsor of a listing in The Trooper received an acknowledgement form which read in part, as follows:

THE TROOPER OFFICAL PUBLICATION OF
TROOPERS LODGE #41

BILLING INFORMATION	ADVERTISER INFORMATION
cost ________	________ name of advertising co. ________ date
total ________	________ street town county zip
	________ tel. no. nature of business
________ method payment	AD INFORMATION
____ check ____ cash	________ size of ad ________ comment
	________ issue

Businesses listing in The Trooper frequently noted on their checks that the payments were for "advertising." The bank account for the "advertising marketing program" was in petitioner's name and was controlled by petitioner.

The number of issues of The Trooper published during the years under consideration were as follows:

Year ended Sept. 30—	*Number of issues*
1976	3
1977	8
1978	4
1979	5
1980	7

Petitioner received the following amounts from OSC for business listings during the years at issue:

Year ended Sept. 30—	*Amounts*
1976	$864,806.00
1977	1,035,264.00
1978	890,973.00
1979	765,448.50
1980	1,068,614.57
Total	4,625,106.07

In its unrelated business taxable income for the taxable years ended September 30, 1976, through September 30, 1979, petitioner included as "gross advertising income" receipts from the large listings but not the receipts from the business directory. For the taxable year ended September 30, 1980, none of the listing receipts were included in unrelated business taxable income.

In his notice of deficiency, respondent determined that all of petitioner's receipts from the listings constituted unrelated business taxable income.

OPINION

Section 511[2] imposes a tax upon a tax-exempt organization's "unrelated business taxable income."[3] Sec. 511(a).

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[2] SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) CHARITABLE, ETC., ORGANIZATIONS TAXABLE AT CORPORATION RATES.—

(1) IMPOSITION OF TAX.—There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) of a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income."

(2) ORGANIZATIONS SUBJECT TO TAX.—

(A) ORGANIZATIONS DESCRIBED IN SECTIONS 401(a) AND 501(c).—The tax imposed by paragraph (2) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section (c)(1)) which is exempt, except as provided in this part of part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

[3] Prior to 1950, a tax-exempt organization's income was not taxable if it was used to further the organization's tax-exempt purposes, regardless of the income's source. See *Trinidad v. Sagrada Orden.*, 263 U.S. 578, 581 (1924); *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951); *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938). The taxation of business income not "substantially related" to an exempt organization's objectives was first imposed by the Revenue Act of 1950 in response to perceived abuses by tax-exempt organizations engaged in profit-making activities. See S. Rept. 2375, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 483, 503-508. These statutes were directed primarily at the problem of unfair competition by tax-exempt organizations. H. Rept. 2319, 81st Cong. 2d Sess. (1950), 1950-2 C.B. 380, 409. As originally enacted, the 1950 Act did not force exempt organizations to abandon commercial enterprises, rather "it struck a balance between its two objectives of encouraging benevolent enterprise and restraining unfair competition by imposing a tax on the

"Unrelated business taxable income" is defined by section 512(a)(1) to mean "the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business." "Unrelated trade or business," in turn, is defined as "any trade or business the conduct of which is not substantially related * * * to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." Sec. 513(a).[4] Therefore, petitioner's business listing receipts are taxable if (1) the publication of the business listings is a "trade or business," (2) it is regularly carried on, and (3) it is not substantially related to petitioner's tax-exempt purposes. Sec. 1.513-1(a), Income Tax Regs.; *United States v. American Bar Endowment*, 475 U.S. __ (1986); *United*

'unrelated business taxable income' of tax-exempt organizations." *United States v. American College of Physicians*, 475 U.S. ___, ___ (1986).

[4] As it relates to this case, the pertinent provisions of section 513 are subsections (a) and (c) which provide:

(a) GENERAL RULE.—The term "unrelated trade or business" means in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)), except, that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual place of employment; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

* * * * * * *

(c) ADVERTISING, ETC., ACTIVITIES.—For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

States v. American College of Physicians, 475 U.S. (1986).

Respondent determined that petitioner's publication of The Trooper constituted an unrelated trade or business within the meaning of section 513 and the receipts therefrom were "unrelated business taxable income" under section 511. Petitioner contests respondent's determination on alternative grounds: (1) The publication of The Trooper does not constitute a trade or business within the meaning of section 513; and (2) even if the publication is a trade or business, the receipts generated from the business listings constitute royalties excluded under section 512(b)(2).

As to the first ground, petitioner concedes that the publication of the paid business listings is regularly carried on and is not substantially related to its exempt purposes. However, petitioner argues that the receipts from the listings are not taxable because: (1) The listings are not advertising; and (2) their publication did not constitute a "trade or business" under section 513(c). Petitioner bears the burden of proof. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a).

We note that neither the Code nor respondent's regulations define the term "advertising" or "advertisement." However, after carefully examining the record and copies of The Trooper we are convinced that both the larger listings and the business listings constitute "advertising." To conclude otherwise we would have to ignore the fact that the vast majority of the listings in The Trooper are composed of slogans, logos, trademarks, and other information which is similar, if not identical in content, composition, and message to the listings found in other professional journals, newspapers, and the "yellow pages" of telephone directories. We also note that the contracts with OSC, FOP's business forms, and the magazine itself repeatedly use such words and phrases as "advertising revenues," "advertisers," "prospective advertisers," "advertising marketing program," and "advertising," to describe the listings and related activities.

With regard to petitioner's argument that the publication of advertising in The Trooper is not a trade or business we note that on December 12, 1967, the Treasury Department promulgated regulations under section 513, as it then existed, concerning the application of the unrelated business tax to business activities constituting only part of a much larger endeavor which is admittedly exempt.[5] In response to criticism of this regulation, section 513(c) was amended, effective January 1, 1970, to read as set forth in the margin at footnote 4. With regard to the amendment, the House committee report stated:

> *Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes that this income should be taxed.*
>
> * * * * * * *
>
> Under this provision, it is anticipated that advertising income from publications (whether or not the publications are related to the exempt purpose of the organization) will constitute unrelated business income to the extent it exceeds the expenses related to the advertising, and, if the editorial aspects of publication are carried on at a loss, to the extent it exceeds this loss.
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> [H. Rept. 91-413 (1969), 1969-3 C.B. 199, 232. Emphasis supplied.]

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[5] The regulations promulgated under sec. 513 at that time contained the following definition of a trade or business:

> (b) *Trade or business.*—The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). *Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.* [Sec. 1.513-1(b), Income Tax Regs. Emphasis supplied.]

In the Senate committee report, the following comments appear:

> *The committee agrees with the House that the regulations reached an appropriate result in specifying that when an exempt organization carries on an advertising business in competition with other taxpaying advertising businesses, it should pay a tax on the advertising income.* * * * For this reason, the committee agrees with the House that the regulations, insofar as they apply to advertising and related activities, should be placed in the tax laws. [S. Rept. 91-552 (1969), 1969-3 C.B. 423, 472. Emphasis supplied.]

Recently the Supreme Court had occasion to consider section 513(c) as amended and stated that "The statute clearly established advertising as a trade or business * * *," [which] "is conceded in this case, as it must be, because Congress has declared unambiguously that the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational articles and editorial content." *United States v. American College of Physicians*, 475 U.S. ___ (1986).

Another factor which supports a finding that petitioner's listings constituted a trade or business is the fact that FOP's arrangements with OSC were obviously conducted with a profit motive and, in fact, were very profitable. The profit is not surprising since under the arrangement, FOP's share of the receipts was based upon gross revenue with no risk or expense involved.

Petitioner would have us discount its profit motive and focus instead upon whether its listing activities constituted unfair competition with others in the advertising field. In so arguing, petitioner asserts that under our rule in *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), affd. 445 F.2d 985 (10th Cir. 1970), cert. denied 404 U.S. 940 (1971), we are constrained to follow the ruling to that effect by the Court of Appeals to which this case is appealable in *Hope School v. United States*, 612 F.2d 298, 303, 304 (7th Cir. 1980). Assuming, without so holding, that the Seventh Circuit's ruling in *Hope School* is still viable after the decision of the Supreme Court in *United States v. American College of Physicians*, *supra*, we disagree with petitioner because we here are faced with different facts from those found in *Hope School*. In that case, an exempt school under section

01(c)(3) solicited contributions by mailing greeting cards to otential donors who could keep the cards without obligaion whether or not they sent the school a contribution. Iere, we are presented with obvious advertising in the nagazine of a section 501(c)(8) organization. Therefore, the lecision in *Hope School* cannot be considered "squarely on point." *Golsen v. Commissioner*, 54 T.C. at 757.

From all of the above, the conclusion is inescapable that petitioner's listing activities constituted advertising and as such amounted to a trade or business. Since petitioner has conceded that such activities were regularly carried on and were not substantially related to its exempt purposes, the receipts from such activities are "unrelated business taxable income."

Petitioner further contends, however, that even if its listing receipts constitute "unrelated business taxable income" under section 513, such receipts are royalties and are excluded from taxation by section 512.

Section 512(a)(1) states the general rule that:

> Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Insofar as applicable here, section 512(b)(2) provides that one of the modifications referred to in subsection (a) is that "there shall be excluded all royalties * * * whether measured by production or by gross or taxable income."

Generally, a royalty is a payment for the use of a right such as a trademark, trade name, service mark, or copyright, whether or not the property represented by the right is used. See, e.g., *Commissioner v. Wodehouse*, 337 U.S. 369 (1949); *Rohmer v. Commissioner*, 153 F.2d 61 (2d Cir. 1946); *Commissioner v. Affiliated Enterprises, Inc.*, 123 F.2d 665 (10th Cir. 1941), cert. denied 315 U.S. 812 (1942); *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938). However, in *Disabled American Veterans v. United States*, 650 F.2d 1178, 1189 (Ct. Cl. 1981), the Court of Claims concluded that royalties excluded under section 512(b)(2):

> are those which constitute passive income, such as the compensation paid by a licensee to the licenser for the use of the licenser's patented invention, * * * or the share of production reserved to the owner of property for permitting another to work mines and quarries or drill for oil or gas * * * [650 F.2d at 1189; citations omitted.]

See also *J.E. & L.E. Mabee Foundation, Inc. v. United States*, 389 F. Supp. 673 (N.D. Okla. 1975), affd. 533 F.2d 521 (10th Cir. 1976).

Whether an item of income falls within one of the modifications provided in section 512(b) is to be determined from all the facts and circumstances in each case. Sec. 1.512(b)-1, Income Tax Regs. In the determination, petitioner has the burden of proof. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a).

On this issue, petitioner contends that it sold to OSC the right to exploit petitioner's name in return for a percentage of the gross advertising revenues and consequently the listing receipts were in actuality royalty payments. On the other hand, respondent contends that the receipts cannot be considered royalties because petitioner's role in the publication of The Trooper was not passive. We agree with respondent because under the various agreements with OSC petitioner had final authority over the content of any issue of the The Trooper and had the right to provide its executive editor, to select the subject of and prepare its editorials and feature articles, to oversee and monitor the solicitor's activities in the advertising program, to control the program's bank account, and to control the reprint of any material published in The Trooper.

We conclude, therefore, that petitioner's role was not passive, the receipts from the listings did not constitute royalties, and such receipts are not excluded under section 512(b)(2) from petitioner's unrelated business taxable income.

Decision will be entered under Rule 155.

GARY H. DRIGGS AND KAY T. DRIGGS, ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 12206-82, 21103-82, 29718-84, 29719-84. Filed September 30, 1986.

Partnership acquired a license to market a computer-assisted translation system in exchange for $5.2 million in cash and 10 percent of sales which, during 8 of the years under the license agreement, could be satisfied by means of $1 million nonrecourse notes. Ps, limited partners of Partnership, sought to deduct cash payments based upon a $13.2 million "principal sum" under sec. 1253(d), I.R.C. 1954, as amended. R contends that the eight $1 million nonrecourse notes should not be recognized for income tax purposes because: (1) They are not contingent payments under sec. 1253(d)(1), I.R.C. 1954, as amended; (2) they should not be considered part of the "principal sum;" and (3) they are too speculative and lack economic significance in relation to the underlying value of the license. Ps contend the $8 million in nonrecourse debt is genuine and supported by the value of the license. *Held*, the eight $1 million nonrecourse notes in this case are not supported by the underlying value of the license and are too contingent and speculative and may not be considered as part of the "principal sum" under sec. 1253, I.R.C. 1954, as amended.

K. Layne Morrill, *Leo R. Beus*, and *Robert C. VanVoorhees*, for the petitioners.

Martha J. Combellick, for the respondent.

GERBER, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Petitioners	*Years*	*Income Tax deficiencies*	*Docket No.*
Gary H. and Kay T. Driggs	1978	$57,280.52	12206-82
	1979	95,879.69	
	1980	38,974.16	
Douglas H. and Effie K. Driggs	1978	20,464.43	12206-82
	1979	38,566.39	
	1980	22,155.09	

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[1] Cases of the following petitioners are consolidated herewith: Gary H. Driggs and Kay T. Driggs, Douglas H. Driggs and Effie K. Driggs, John D. Driggs and Gail D. Driggs, docket No. 12206-82; Leo A. and Shirley A. Weidner, docket No. 21103-82; Kathryn A. Mullikin, docket No. 29718-84; and Howard M. Snyder and Virginia Snyder, docket No. 29719-84.

Petitioners	*Years*	*Income Tax deficiencies*	*Docket No.*
John D. and Gail D. Driggs	1978	19,677.97	12206-82
	1979	52,654.41	
	1980	40,448.92	
Leo A. and Shirley A. Weidner	1977	6,712.00	21103-82
	1979	24,704.55	
Kathryn A. Mullikin	1980	63,263.00	29718-84
Howard M. and Virginia Snyder	1980	26,545.68	29719-84

The above-listed cases have been consolidated for purposes of trial, briefing, and opinion. Petitioners are related by their common interest in a partnership which engaged in a transaction that generated the claimed tax benefits being questioned by respondent. With one exception,[2] all other unrelated issues contained in the respective statutory notices have been settled or resolved by the parties. The remaining issues concern the acquisition of a 20-year license to market a computerized translation system known as the "Span-Eng System." The controversy centers on the use and interpretation of section 1253,[3] concerning the amortization of license fees, and section 709, concerning whether other fees are deductible or to be capitalized.

More specifically, the issues presented are: (1) Whether nonrecourse notes constitute "contingent payments" within the meaning of section 1253(d)(1); (2) whether "payments" by means of nonrecourse indebtedness are to be considered part of the "principal sum" within the meaning of section 1253(d)(2); (3) whether the nonrecourse indebtedness is too speculative and contingent to be recognized and whether it lacks economic significance in relation to the value of the underlying asset(s); and (4) whether amounts paid to a general partner as "sponsor's fees" are deductible expenditures or syndication costs which are to be capitalized.

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[2] The parties are attempting to work out an agreement to be bound by the outcome of a group of cases being considered by another judge with respect to a common issue involving CSA-BL 1977 Leasing for petitioners Gary H. and Kay T. Driggs' 1978 and 1979 taxable years in docket No. 12206-82.

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the years in issue.

FINDINGS OF FACT

Some of the facts in this case have been stipulated by the arties and their stipulations and attached exhibits are acorporated by this reference. All of the petitioners in ocket No. 12206-82 resided in Arizona at the time of the iling of their petition. Petitioners Weidner (docket No. 1103-82) resided in Utah at the time of filing their petition. etitioners Mullikin (docket No. 29718-84) and Snyder docket No. 29719-84) resided in California at the time of iling their petitions.

General Background

Each of the petitioners purchased limited partnership interests in Span-Eng Associates (Partnership), a Utah partnership formed on October 1, 1979. Partnership's purpose was to acquire a license, market, sell, and service Span-Eng Systems (System). System is computer software which provides computer-assisted language translation of Spanish to English and English to Spanish by means of a "DEC 11/34" mini-computer and word processor. System was originally developed by Weidner Communications Systems, Inc. (Communications), incorporated on July 28, 1977, in Utah by petitioner Leo A. Weidner's relatives, Bruce and Stephen Weidner, and Carter Jones, Jr. Petitioner Leo A. Weidner was named a director and vice president of Communications. Communications initially employed the technical know-how of the System's innovator, Inns of the Temple, Inc., an institution run by Bruce Wydner (brother of Stephen Weidner, 100-percent shareholder of Communications).

Communications also worked with Eyring Research Institute of Provo, Utah, in furthering development of System. Communications had slightly more than $400,000 in working capital available during the time of System's development. Communications' financial statements reflect $89,013 in accumulated research assets, and $183,047 in accumulated research and development expense, through March 31, 1979. Communications, on June 18, 1979, agreed to pay $20,000 to Inns of the Temple, Inc., for its interest in System.

Weidner Marketing, Inc. (Marketing), was incorporated in Utah on September 28, 1979, as Communications' wholly owned subsidiary and marketing arm. Span-Eng Associates (Partnership), was formed to provide funding for Communications' activities in producing and marketing System. Alta Communications, Inc. (Alta), originally incorporated in Utah on December 4, 1978, was to be the general partner of Partnership and was controlled by Stephen Weidner.

Span-Eng Associates (Partnership)

Alta promoted the sale of limited partnership interests by means of a private placement memorandum, dated July 6, 1979. Alta was to receive 10 percent of the total proceeds ($6,160,000) of the offering as a "sponsor's fee." The $616,000, was to be paid in $308,000 installments during 1979 and 1980. Alta was paid "sponsor's fees" of $308,000 during 1979 and $188,900 during 1980. Walker Bank & Trust offered financing terms whereby prospective limited partners could borrow 75 percent of the required cash investment with recourse evidence of indebtedness. Petitioners each invested in Partnership and claimed losses as follows:

Investor-petitioner's name	*Total cash investment*	*Amount paid in 1979*	*Amount paid in 1980*	*Losses claimed as attributable to partnership*	
				1979	*1980*
Gary and Kay Driggs	$176,000	$88,000	$88,000	$82,781	$71,309
Douglas and Effie Driggs	88,000	44,000	44,000	41,391	35,655
John and Gail Driggs	176,000	88,000	88,000	82,781	71,309
Leo and Shirley Weidner	88,000	88,000	...	82,781	...
Howard and Virginia Snyder	88,000	...	88,000	...	75,673
Kathryn Mullikin	88,000	...	88,000	...	75,688

The private placement memorandum offered 35 partnership units at $176,000 each[4] to raise $6,160,000 total proceeds from the offering. As of October 1, 1979, 18 of the $176,000 units of Partnership remained unsold. Through a corporate entity named Nokomis, Inc,, Stephen Weidner purchased the 18 unsold units with funds borrowed from Walker Bank & Trust. Between October 1, 1979, and December 31, 1979,

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[4] Although each unit was offered for $176,000, investors were permitted to purchase an $88,000 one-half unit which was the minimum cash investment offered.

.5 of the 18 "Nokomis units" were resold to unrelated vestors. The apparent purpose of the October 1, 1979, Nokomis transaction" was to close the offering and ccomplish full funding, thus enabling Partnership to meet s commitments.

The License Agreement

Partnership and Communications entered into an October , 1979, agreement granting to Partnership the exclusive lomestic rights to promote, distribute, and market System for 20 years in exchange for a stated consideration of $13,200,000. The $13,200,000 was to be paid as follows: (1) $2,600,000 to Communications in cash on October 1, 1979, and April 1, 1980. (2) $1 million to Communications each year beginning 1985 through 1992, which at Partnership's option could be satisfied each year by means of a nonrecourse note. The nonrecourse notes would have been secured only by the assets of Partnership, including proceeds of sales of System. (3) 10 percent of gross sales to Communications to the extent that 10 percent of gross sales exceeded the two $2,600,000 cash payments and "cash or actual" payments on any of the nonrecourse notes.

Partnership could terminate the license agreement upon 30 days' notice, so long as termination was not conditioned upon Communications' default. Presumably, Partnership's termination of the license without cause would not entitle Partnership to any return of its cash payments.

Partnership paid Communications $2,600,000 for license fees on October 1, 1979. During 1980, Partnership "paid" Communications $2,326,560 for license fees composed of $1,225,560 paid directly to Communications, $66,000 paid indirectly through credit entries at Walker Bank & Trust, and $1,035,000 paid to Marketing at Communications' direction. No other license fees payments were ever made by Partnership and the license agreement was terminated in 1982.

The Sales Agency Agreement

On October 1, 1979, Partnership and Marketing entered into a "Sales Agency Agreement" wherein Marketing became the exclusive domestic selling agent of Partnership. Marketing was to receive 15 percent of the gross selling price of each System. The sales agency agreement was to expire on December 31, 1980. System was to sell for $155,000 per unit composed of the translation software and hardware (a mini-computer). The hardware portion of System represented less than $100,000 of System's cost. Very few sales of System occurred during the 15-month sales agency agreement period.[8]

Partnership was to acquire each translation system from Communications at a 35-percent discount from the gross selling price. Essentially, Partnership's return was 20 percent of the gross selling price of System (35-percent discount less 15-percent sales agency agreement commissions). Prior to October 1, 1979, limited advertising and product exposure of System was accomplished by Communications. System was shown at the American Translators Association's fall 1978 convention in New York City. System was reported in a newspaper and magazine. Brochures and sales presentations were developed, and a Washington, D.C., sales office was opened. Subsequently, Boston and Chicago offices were opened. During the spring of 1979, Communications did not have sufficient funding to adequately market System.

The Results

Subsequent to the injection of capital via Partnership, little of the contemplated marketing was accomplished by Marketing, Communications, Alta, or Partnership. During the fall of 1980, an officer of Communications quit because of strained relations, his belief that company management was, to some degree, unethical, and because System's product potential did not materialize. At that same time, Communications' board of directors was informed that Stephen Weidner was under Federal investigation in connection with his syndication of "coal interests." Communications' board engaged the accounting firm of Deloitte, Haskins and Sells to determine how Partnership's payments to Communications had been utilized.

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[8] The record is hazy on this point, but it appears that less than 5 Systems were sold between Oct. 1, 1979, through Dec. 31, 1980.

Deloitte, Haskins and Sells determined that Stephen
Veidner had caused Communications to enter into about $2
illion in consulting agreements with corporations owned
y Stephen Weidner. Other misappropriations of Communi-
ations' funds were reported by the accounting firm. As a
esult, some of Partnership's limited partners filed suit
eeking damages against Stephen Weidner. The limited
artners alleged that Stephen Weidner had made false
epresentations as to projected cash-flow, sales, earnings,
and returns on capital at risk regarding System. The suit
was settled on June 1, 1981, by Stephen Weidner's transfer-
ring all of his Communications stock to the limited partners
of Partnership. Partnership's limited partners also sued
Peat, Marwick, Mitchell & Co., Alta, and Dr. Stanford[6]
alleging, in part, that the projections in the offering
memorandum significantly overstated Systems' earnings
projections. At about the same time, Alta resigned as
Partnership's general partner.

In December 1982, an unrelated company purchased 51 percent of the outstanding shares of Communications for $3,065,000, composed of $1,500,000 cash and $1,565,000 in promissory notes. The purchaser also loaned $2 million to Communications. At about the same time, Partnership's license agreement for System was terminated.

System's Uses, Potential and Value

System was designed to assist professional translators. Written material, in one language, is entered and the System translates it into the second language. The System does not provide word-for-word translation, but generally provides sentence-sized groupings of words with a similar or the same meaning in the second language. The translation is about 80-percent accurate, and a professional translator must accomplish necessary refinements and other editing. System provides synonyms for selection by the professional translator and a split screen which permits comparison of the material in both languages. System's core dictionary is 8,000 to 15,000 word-pairs and may be expanded by the user to accommodate up to 1 million word-pairs.

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[6] Dr. Melvin J. Stanford had prepared a market and financial study for Communications. The market projections were utilized in the offering materials.

System assisted in translations at an average rate of 450 to 600 words per hour. System's promoters believed that for short periods of time it could assist in achieving over 1,000 words of translation per hour.[7] Manual translation (without computer assistance) is accomplished at a 150 to 200 average word-per-hour rate. Based upon the number of words per hour, it was projected that System would assist in translating at a cost of 3 to 5 cents per word. Actual use by Princeton International Translators, Inc. (one of the earliest purchasers and users of System), resulted in a cost of about 5 cents per word. The cost of manual translation during 1979 ranged from 4 to 9 cents per word. Accordingly, machine-assisted translations, although about 3 times faster than manual translations, may have been more costly to produce on a per-word basis because of the substantial capital investment in the computer hardware and software.

During 1980, System was considered a new technological product requiring further software refinement. One large company tested System on a 12-month basis and decided against permanent use because System failed to meet its productivity goals. System was designed to be used in an interactive manner by a translator. The 12-month test was conducted without the interactive use by translators. Typists would type the words into System, and hard copy was produced and pencil-edited by translators. Accordingly, during the early stages of System's development, its most efficient use was by a translator who interacted with System. This factor and a market and financial study by Dr. Melvin J. Stanford[8] would appear to limit System's application to professional translators. Dr. Stanford's report indicates that translators are relatively transient. The universe of translators is generally composed of smaller service-oriented organizations for which System would be an extraordinary expenditure. No evidence was introduced of fully successful use of System prior to 1982, when Partnership's license agreement with Communications was terminated. Although Dr. Stanford had researched and written a report on the translation industry, that industry had very limited experience with computer-assisted translation. Furthermore, Dr. Stanford's reports and research did not focus specifically upon the need for translation to and from English or Spanish, which to some extent would have reduced the projected market for System.

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[7] Translation work causes fatigue, resulting in reduced productivity. A translator without technological machine assistance may achieve 400 to 450 words of translated material for the first hour and progressively fewer words in each successive hour, resulting in a daily average of 150 to 200 words of translation per hour. In a similar manner, the human involvement in machine-assisted translation may permit a 1,000-words output for the first hour with successive reductions, resulting in a 450 to 600 average hourly rate on a daily basis.

[8] Dr. Stanford's May 1979 revised edition, indicates that "most individuals or organizations requiring translation look to the services of translation agencies or free lance translators." Moreover, only 10 percent of translators are full-time and 90 percent of entrants into the translation industry will fail within 5 years. Accordingly, these factors would reduce the number of potential customers among large corporate entities.

The accounting firm of Peat, Marwick, Mitchell & Co., during 1979, prepared financial projections based upon data from Communications and Dr. Stanford's reports. These financial projections, which were included in promotional materials, were based on the assumption that the data supplied were correct or appropriate, but without any verification of same by Peat, Marwick, Mitchell & Co. Dr. Stanford projected sales of 22 Systems for 1980, doubling to 44 in 1981, and thereafter increasing 50 percent annually and leveling off at 134 Systems in 1984 and beyond. Assuming a $155,000 sales price for each System, Partnership's gross receipts, after reduction for 15-percent selling fees to Marketing and net earnings before taxes, were generally projected as follows:

Year	*Number of sales projected in Stanford report*	*Gross receipts to partnership at 20 percent of $155,000 per unit*	*Net earnings to limited partners before taxes and payment of debt service*
1980	22	682,000	($1,995,600)
1981	44	1,445,800	1,373,300
1982	66	2,298,800	2,207,400
1983	99	3,655,200	3,534,700
1984	134	5,244,400	5,097,500

The limited partner-petitioners were to have a passive role in promotion and sales and their involvement in System was basically limited to being a source of financing. Their return was limited to 20 percent after sales expenses, and a slightly smaller net return after operating expenses. The limited partners were liable to Communications only to the extent of their cash investments and recourse loans totaling $5,200,000. The $8 million nonrecourse amounts were essentially payable out of 10 percent of the revenues. Only considering recourse notes and cash investment and based upon projected net earnings, the limited partners were to receive no less than a 10-percent return and as much as a 100-percent return in years after 1983. These percentages do not consider tax benefits that were anticipated for limited partner-investors.

Dr. Stanford's market and sales projections were unrealistically high and overstated. This was particularly so since the product was not well known to the market, and it was not cost competitive with manual translation. It also appears that the necessary capital expenditure ($155,000) would have substantially limited the potential market. In addition, it was not known what percentage of the users of translations had a need for the Spanish-English language program, which was the only software available in 1979. Dr. Stanford also overestimated the word-per-hour capacity of System at 2,000 in evaluating its market potential.

Respondent's proffered expert, American Technology Appraisal Service, through a report and the testimony of Jonathan C. Moody (Moody), proposed a value for the System license of "approximately $300,000, at a maximum, including profit to the developer, for the [System]." Moody treated System merely as software with a development cost of $300,000, based upon 20,000 lines of code or "nine man-years" of effort. Moody ignored the developer's technological expertise and "know-how." He did not consider goodwill, the sales and marketing availability of Communications and Marketing, or the potential market. Moody also failed to consider the effective integration of the software with less expensive, compatible hardware. In prior applications larger, more expensive hardware was required.

Petitioners' proffered expert, Wasatch Advisors, through a report and the testimony of Samuel S. Stewart, Jr. (Stewart), proposed a value range for the license from $5,071,400 to $8,342,800, depending upon the method of valuation. Stewart used an income, a transaction, and two market value approaches. In each approach, with the exception of the "transaction value" approach, the projections of the Stanford report were used. A rate is applied to the Stanford report's projected earnings or cash-flow. The rates were variously derived from rates returned by "comparable" companies, average rates of return from various investments, along with an inflation factor and a price earnings approach. The "transaction value" looks to the willing buyer and seller, and petitioners' expert opined that the 35 limited partnership units sold for $176,000 each for a value of $6,160,000 and, accordingly, had that value. This approach is normally used where there is an established market for the asset, such as a stock exchange.

The value of the System license as of October 1, 1979, was no more than $5,200,000.

The Sponsor's Organization Fee

Alta was to receive 10 percent of the gross proceeds from sale of limited partners' units, or $616,000, as a "Sponsor's Organization Fee." Costs for legal, accounting, printing, and Blue Sky registration relating to the organization of Partnership were separately referenced in the offering memorandum and were to be borne by Partnership. Alta was to pay commissions, fees, and other expenses of the offering from its "Sponsor's Organization Fee." If Partnership units were sold by others, Alta was authorized to cede part or all of its 10-percent "Sponsor's Organization Fee" to the seller. Partnership paid Alta $308,000 in 1979 and $188,900 in 1980 as "Sponsor's Organization Fees." Partnership treated these payments as currently deductible and limited partners claimed losses for 1979 and 1980 and their income tax returns apportioned shares of the $308,000 in 1979 and $188,900 in 1980.

OPINION

Petitioners entered into a licensing transaction which was designed and structured to provide tax benefits by compliance with section 1253. Respondent questioned both the substance of petitioners' transactions and their compliance with the statute and regulations. Petitioners seek amortization deductions for payments made under the license agreement. Although the 1979 and 1980 payments were made in cash, we must consider: (1) Whether nonrecourse notes (which may be used to satisfy future obligations under the agreement) may be treated as "payment" for purposes of section 1253; (2) whether the nonrecourse notes had economic substance; and (3) whether the nonrecourse notes were supported by the underlying value of the license.

Statutory Background - Section 1253

Diversity among the Federal Circuit Courts of Appeals and lower courts motivated Congress to enact section 1253 as part of the Tax Reform Act of 1969, effective for transactions after December 31, 1969. Confusion existed in determining whether a transfer of a franchise was to be treated as a sale or license and, accordingly, whether the transferor was to receive capital gains or ordinary income treatment. S. Rept. 91-552 (1969), 1969-3 C.B. 423, 554. Under section 1253, retention of "any significant power, right, or continuing interest" in the franchise will result in ordinary income treatment to the transferor. The parties agree that the franchise under consideration was licensed and not sold to Partnership.

Prior to the enactment of section 1253, payments to acquire a franchise were not deductible as depreciation or amortization because "franchises * * * are considered to be intangible assets with unascertainable useful lives." S. Rept. 91-552, *supra*, 1969-3 C.B. at 555. The amount and timing of deductions by a franchise licensee are governed by section 1253(d). Payments contingent "on the productivity, use, or disposition of the franchise" are contemporaneously deductible under section 162(a). Sec. 1253(d)(1).

"Non-contingent" or "other payments" are divided into three categories. A single payment is ratably deductible over the shorter of 10 years or the term of the license agreement.[9] Sec. 1253(d)(2)(A). Where the payment is part of a series of approximately equal payments for more than 10 years or the entire term of the franchise license, the payments are contemporaneously deductible. Sec. 1253(d)(2)(B). All other payments are to be treated in accordance with regulations promulgated "by the Secretary." Sec. 1253(d)(2)(C).

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[9] The measurement of these terms generally throughout sec. 1253 begins with the year in which the first payment is made.

Pursuant to section 1253(d)(2)(C), proposed regulations were published July 15, 1971, but final or permanent regulations have not been published or issued.[10] The proposed regulations provide for three situations not specifically covered in the statute. Section 1.1253-1(c)(3)(iii), Proposed Regs., 36 Fed. Reg. 13,150 (July 15, 1971), covers a series of approximately equal payments for a period of less than 10 years. Essentially, the payments, in aggregate, would be ratably deductible for the shorter of 10 years or the term of the license. Section 1.1253-1(c)(3)(iv), Proposed Regs., 36 Fed. Reg. 13,150, involves a series of unequal payments for more than 10 years or the term of the license. This subsection would permit a deduction in the year of payment so long as the payment is no more than 20 percent of the "principal sum" and no more than 75 percent of the "principal sum" is paid in the first half of the license term or 10 years, whichever is shorter. Section 1.1253-1(c)(3)(v), Proposed Regs., 36 Fed. Reg. 13,150, covers unequal payments for 10 years or less and where the license term is longer than the payment schedule. A ratable deduction is permitted over the shorter of 10 years or the term of the license so long as the total ratable amounts do not exceed the total actual payments during any year. Finally, the proposed regulations provide that other possible circumstances of payment may be submitted in writing to respondent for a determination of the amount and timing of permissible deductions.

In order to apply the formulae of the statute or proposed regulations, we must first determine the "principal sum" for the license, whether payments are contingent or "other payments," and whether the payments are "equal" or "unequal."

The "Principal Sum" Under Section 1253

The amounts and timing of the payments structured by the promoters of interest in Partnership were designed to take advantage of the deductions that would be permitted under the terms of section 1.1253-1(c)(3)(iv), Proposed Regs., *supra*. The 20-year license term exceeds the 10-year minimum and the payments were to be unequal—$2,600,000 in 1979 and 1980 and $1 million annually for 8 years, beginning 1985. Under these circumstances, each payment would be deductible in the year of payment, so long as no payment exceeds 20 percent of the "principal sum" and no more than 75 percent of the "principal sum" is paid in the first half of the license term. Under the terms of the offering memorandum, the "principal sum" was to be $13,200,000 and, accordingly, the $2,600,000 payments in 1979 and 1980 would each be $40,000 less than 20 percent ($13,200,000 × .20 = $2,640,000). In a similar manner, the $1 million payments were delayed 4 years to permit compliance with the 75-percent requirement. Under the 75-percent requirement, no more than $9,900,000 could be paid and deducted before 1989. Considering the $2,600,000 proposed payments in 1979 and 1980 and the four $1 million payments from 1985 through 1988, the payments would have fallen $700,000 short of the $9,900,000, at $9,200,000. If the $1 million nonrecourse notes are considered "payments" and all payments are "non-contingent," then each of Partnership's investors would be able to "write-off" nearly 85 percent of their cash investment during the first 2 years.[11] Respondent questions whether the eight $1 million nonrecourse notes can be considered part of the "principal sum" or whether they have economic significance. If they are part of the "principal sum," respondent contends that the $1 million amounts are contingent.

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[10] Petitioners and respondent have briefed their respective positions relying upon the above-referenced proposed regulations. Petitioners have not argued or contended that the proposed regulations are invalid or without legal stature. Although our opinion does not conflict with the proposed regulations, we do not rely upon them as authority because they "carry no more weight than a position advanced on brief by the respondent." *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970); *Miller v. Commissioner*, 70 T.C. 448, 460 (1978). See also *Mearkle v. Commissioner*, 87 T.C. 527 (1986).

In *Jackson v. Commissioner*, 86 T.C. 492 (1986), we recently held that a nonrecourse note can constitute "payment" for purposes of section 1253(d)(2). Our holding was that "payment" in section 1253 was not dependent upon cash or cash equivalence, but that the use of notes or other valuable property can constitute payment. We found that the use of notes or other valuable consideration can constitute payment under section 1253(d)(2). However, there must be economic substance supporting the existence and stated value of the debt obligation for the note or other property to constitute payment. *Jackson v. Commissioner*, *supra* at 521. Accordingly, we must focus upon respondent's contention that the nonrecourse notes lack economic substance or are contingent and speculative.

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[11] Partnership was to have 35 partners, each of whom invested $176,000 for a total of $6,160,000. Of that amount, $5,200,000 was to be paid to Communications during the first 2 years. Accordingly, 84.4 percent of cash investments ($5,200,000 - $6,160,000) would be "written-off," or $148,544 for each $176,000 investment and $74,272 for each $88,000 investment. We observe that this is not a highly leveraged investment and the proposed ratio of cash to debt was most conservative.

Nonrecourse Notes - Economic Substance - Contingent or Speculative

Numerous opinions analyze nonrecourse notes to determine whether they should be considered as part of the basis of property for purposes of depreciation, gain, or loss. E.g., *Tufts v. Commissioner*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947). Here, the issues involving nonrecourse notes do not directly involve deductibility of the notes. Instead, we focus upon the notes' "role" in the formulae contained in section 1253 and the proposed regulations. The claimed deductions of the cash payments are dependent upon the nonrecourse notes being considered a part of the "principal sum." The standards for nonrecourse notes should not vary under these circumstances. Respondent argues that the nonrecourse notes lack economic substance because the purchase price or "principal sum" exceeded the value of the underlying license, at least by the $8 million to be represented by the nonrecourse notes. Petitioners argue that the $8 million indebtedness is genuine and supported by the value of the license. Petitioners also point out that should the license's value be less than $13,200,000 as the result of a "bad bargain," there remains "an actual investment." In other words, petitioners urge us to use a good-faith standard. Petitioners argue that so long as the price was set at arm's-length and without collusion, respondent and the courts must accept the ensuing results. We cannot agree. We are not compelled to give credence to nonrecourse debt merely because the parties dealt at arm's length or were without business acumen. That is not to say that we must disregard the existence of a sale if the purported sales price is not, for tax purposes, the amount stated in the agreement. *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976), affg. 64 T.C. 752 (1975).

To secure a tax benefit based upon the form of a transaction, a taxpayer must show the existence of some economic significance or bona fide purpose other than the avoidance of tax. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). More specifically, petitioners must show that the nonrecourse notes have economic significance in the context of the subject transaction. If the stated purchase price unreasonably exceeds the value of the interest acquired (or when the principal amount of the note unreasonably exceeds the value of the property securing the note), the liability relied upon for a tax benefit may not be considered genuine or having economic significance. *Estate of Franklin v. Commissioner, supra* at 1049; *Hager v. Commissioner*, 76 T.C. 759, 773-774 (1981). We have found that the value of License as of October 1, 1979, was no more than $5,200,000. Our finding is based upon the following considerations: (1) As of October 1, 1979, only an inconsequential amount of advance marketing had been accomplished. (2) The response from marketing in advance of October 1, 1979, was not sufficient to value the license at more than $5,200,000. (3) Dr. Stanford's market studies did not support the ultimate potential sales projections because: (a) Dr. Stanford accepted inflated translation production estimates and costs from Stephen Weidner or Communications; (b) the market study did not focus upon the need for Spanish-English translation; and (c) the market study did not appropriately consider the relatively large capital expenditure in relation to the ability of potential purchasers to return a profit after considering capital investment. (4) The product was not fully tested and possessed numerous problems common to new products.

Moreover, the transaction was structured so as to render the existence of the nonrecourse notes totally economically insignificant to either party. The sole purpose for the nonrecourse notes was to permit investors to deduct their cash investment on the front end of the transaction by simulating compliance in form with section 1.1253-1(c)(3)(iv), Proposed Regs., *supra*. Under the terms of the license agreement, Partnership was to make two $2,600,000 payments in 1979 and 1980. Five years later, Partnership was to commence annual aggregate payments of $1 million which could be satisfied, at Partnership's option, by means of 6-percent simple interest nonrecourse notes. In addition to those terms, Partnership was to pay Communications 10 percent of gross sales, but any of the $2,600,000 payments would be "credited against" the 10 percent. In a similar manner, payment by means of the $1 million nonrecourse note could be obviated by remittance of 10 percent of gross sales, if gross sales exceeded the balance of outstanding nonrecourse notes. The net effect of this agreement is a 20-year license in exchange for 10 percent of gross sales or $5,200,000, whichever is larger. The insignificance of the nonrecourse notes is further highlighted by Partnership's option to terminate or walk away from the license agreement without penalty upon 30 days' notice.

In a similar vein, courts have found promissory obligations to be too contingent to be considered part of a taxpayer's basis or to be considered effective to obtain other tax benefits. *Denver & Rio Grande Western R.R. Co. v. United States*, 205 Ct. Cl. 597, 505 F.2d 1266 (1974); *Estate of Baron v. Commissioner*, 83 T.C. 542, 549-550 (1984), affd. 798 F.2d 65 (2d Cir. 1986); *Saviano v. Commissioner*, 80 T.C. 955, 962-963 (1983), affd. 765 F.2d 643 (7th Cir. 1985). Petitioners have argued that the too speculative or contingent rationale is limited to situations where taxpayers are relying upon the promissory obligation for a deduction. In other words, petitioners suggest that there must be a direct relationship and reliance upon the note as payment before the rationale is applied. We disagree. The question is whether the notes or obligation should be given any effect, either as part of a formula to compute a deductible amount or as the deductible amount. Petitioners also contend that the speculative and contingent rationale should be employed only where a taxpayer abuses the spirit while honoring the letter of the statute or regulation. It is not necessary to first find that a transaction was a gross abuse of tax statutes or principles before we find that its substance is different from its form.[12] There were no underlying capital assets to secure the nonrecourse notes. The notes were essentially only payable if 10 percent of gross sales did not exceed the stated note balances.[13] It appears clear that any shortfall would not have been paid because of the failure to generate sales, the only source of revenue or assets for Partnership or Communications. As previously discussed, the sales projections were excessive and the notes, in addition to having no business or "non-tax" purpose in the transaction, were too contingent and speculative to be considered part of the purchase price for purposes of section 1253 or other tax benefits. Accordingly, we hold that the $8 million portion of the purchase price is not a part of the "principal sum" for purposes of computing the amount and timing of deduction under section 1253.

Petitioners, as an alternative position, argue that if the purchase price (or "principal sum") is found to be $5,200,000, then Partnership would be entitled to $520,000 in amortization deductions in 1979 and 1980. Petitioners argue that this result is provided for in section 1.1253-1(c)(3)(v), Proposed Regs., *supra*, because the actual payments were unequal although the agreement called for two payments of $2,600,000. Section 1.1253-1(c)(3)(v), Proposed Regs., *supra*, covers unequal payments for 10 years or less where the license term is larger than the payment schedule.

Respondent agrees that Partnership would be entitled to $520,000 amortization for 1979 and 1980, and refers us to section 1.1253-1(c)(3)(iii), Proposed Regs., *supra*, which provides for equal payments for 10 years or less. The parties' agreement on a 10-year ratable amortization schedule, or $520,000 per year, obviates the need to resolve whether the 1979 and 1980 payments are equal or unequal for purposes of this case. We hold that Partnership (and each of the petitioners in an amount in accord with his partnership interest) is entitled to amortize $520,000 of License during 1979 and 1980.

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[12] The ratio of deductions to investments does not appear abusive in amount (less than 1 to 1). Respondent has not questioned profit motive and we do not consider or find that Partnership or petitioners were not engaged in an activity for profit.

[13] We have assumed that Partnership would not pay $1 million cash if it was permitted to use 6-percent simple interest nonrecourse notes only payable out of revenues from the asset for which the notes are purported payment.

Sponsor's Fees

The private placement memorandum provided for "sponsor's fees" of 10 percent of receipts from the sale of Partnership interest to Alta, the general partner. The total $6,160,000 partnership offering would have generated "sponsor's fees" totaling $616,000. The stated purpose of the "sponsor's fees" was—

> for organization of the Partnership * * * out of which [Alta] may pay commissions and fees of up to 10 % of the amount received by the Partnership and [Alta] will pay all other costs in connection with the Offering other than legal and accounting fees, printing costs and Blue Sky qualification expenses, which will be paid by the Partnership. * * *

Under section 709(a), no deduction is generally allowed for amounts paid to organize a partnership or to promote a partnership interest. Section 709(b) provides for 60 months' amortization of organization fees, if they (1) are incidental to creation of the partnership, (2) are chargeable to the capital account, and (3) are of an amortizable character. Section 709(b) is available only if properly elected. Under the regulations, issued in 1983 and retroactive for taxable years beginning after December 31, 1975, syndicated expenses must be capitalized and are not subject to the section 709(b) election. Sec. 1.709-2(b), Income Tax Regs. Other examples of expenses not subject to the section 709(b) election include expenses connected with acquiring partnership assets and admission or removal of partners after the partnership is organized. Sec. 1.709-2(a), Income Tax Regs.

The parties have stipulated and have agreed that Partnership paid "sponsor's fees" to Alta of $308,000 in 1979 and $188,900 in 1980. Each of the limited partners claimed his apportioned share of these amounts in the year of payment. On Partnership's Federal income tax return for 1979, a "709(b) election" was made with respect to amortization of $72,006 in "organization costs." The $308,000 sponsor's fee[14] was claimed as a current deduction. The 1980 partnership return referenced the $72,006 "organization costs" and claimed 12 months' amortization. The $188,900 "sponsor's fee" was claimed for 1980 as a current deduction. The record is otherwise void of detail which would permit us to delineate whether the $308,000 and $188,900 "sponsor's fees" were composed of commissions for sales of partnership interests (syndication fees) or were for organization costs.[15]

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[14] The $308,000 was claimed as part of a $323,000 amount.

Petitioners, on brief, "concede that a portion of [the sponsor's] fees were for syndication expenses." Petitioners then argue that the offering memorandum permitted Alta to pay organizational-type expenses. After admitting that "An exact tracing [of sponsor's fees] is unfortunately not possible," petitioners suggest that the division between organization and syndication expenditures may be reconstructed by means of extrapolation. Petitioners suggest that by analyzing all of the checks written and ledger accounts of Alta for 1979 and 1980 one would be able to break down expenditures into those for syndication, not for syndication, or for miscellaneous expenditures. Thereafter, ratios or percentages would be developed and applied to the $308,000 and $188,900 claimed sponsor's fees. Petitioners, unfortunately, have not provided evidence in the record which would permit us to corroborate, verify, or understand their choice of the category in which each check should be classified. Although petitioners have provided the summarized totals from which they suggest we could delineate expenses, the number provided is not sufficient to carry petitioners' burden of establishing that the "sponsor's fees" are deductible. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Accordingly, we find that petitioners are not entitled to deduct the $308,000 and $188,900 "sponsor's fees" claimed for the taxable years 1979 and 1980, respectively.

Decisions will be entered under Rule 155 in all dockets.

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[15] If we were to determine that any portion of the "sponsor's fees" were "organizational expenses," they would be amortizable over 60 months and not fully deductible in the year of payment, as claimed on the 1979 and 1980 partnership returns.

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UNITED STATES
TAX COURT

REPORTS

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joint venture could not have anticipated a profit from transactions, Court determined that investment tax credits and business expense deductions were properly disallowed, since transactions between joint venture and group were independent of and unaffected by underlying lease transactions between group and third-party lenders and lessees and were without economic substance, and joint venture acquired no interest in computer equipment. *James v. Commissioner* 905

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transferred to purchaser was required to be included in income of transferor, and hence petitioners, in 1980 under tax benefit rule and sec. 111, since liquidating distribution was fundamentally inconsistent with premise upon which sec. 162 deduction was based. *Byrd, Transferee of Assets of Eastern Shore Nursery, Inc. v. Commissioner* 830

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notes were initially fully recourse, but could convert to nonrecourse on occurrence of certain contingencies; and each of videotapes was purchased from a corporation either directly or indirectly controlled by A, who effectively controlled all aspects of the transactions, while petitioner's primary activity involved obtaining investors for the partnerships, Court determined (1) purchase transactions were in substance shams lacking economic significance beyond expected tax benefits (*Falsetti v. Commissioner*, 85 T.C. 332); and (2) petitioner was liable for additional interest under sec. 6621(d) with respect to amount of underpayments attributable to basis claimed in property, since such underpayments were attributable to tax-motivated transactions. *Helba v. Commissioner* 983

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UNITED STATES TAX COURT

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beginning of an administrative proceeding to audit X's 1982 partnership information return; and on Apr. 25, 1985, Commissioner mailed petitioners statutory notice determining deficiencies for 1979-82, Court determined (l) partnership audit and litigation provisions of secs. 6221-6233 applied to X's 1982 partnership taxable year; (2) petitioners' distributive shares of X's claimed loss and investment tax credit for 1982 were "partnership items"; (3) carryback of investment tax credit to 1979-80, sec. 6659 addition to tax for 1979-80 and 1982, and sec. 6653(a) addition to tax for 1981 to extent its existence or amount was determinable by reference to a partnership adjustment were "affected items"; (4) portion of deficiency attributable to an affected item is a "deficiency attributable to a partnership item" within meaning of sec. 6225(a), and Court has no jurisdiction in a partner's personal tax case over any such portion. *Maxwell v. Commissioner*.............. 783

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entitled to award for value of his own services, since he was barred by plain language of statute from recovering compensation for his own time spent in litigating his own case; and (3) petitioner was entitled to award of $1,860 in litigation costs for services of expert witness and cost of filing petition. *Frisch v. Commissioner* 838

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REPORTS

OF THE

UNITED STATES TAX COURT

MELVIN C. AND GWEN NIELSEN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 23401-85. Filed October 6, 1986.

Petitioners filed 1978 and 1979 Forms 1040, U.S. Individual Income Tax Returns, prior to Jan. 1, 1982. After that date, petitioners filed 1978 and 1979 Forms 1040X, Amended U.S. Individual Income Tax Returns, to claim refunds because of carrybacks of investment tax credits claimed in 1981 and 1982. Respondent seeks additions to tax for years 1978 and 1979 under sec. 6659, I.R.C. 1954, as amended, based on underpayments of tax for those years attributable to valuation overstatements associated with the investment tax credits. Sec. 6659 applies to returns filed after Dec. 31, 1981. Sec. 722(a)(4) of the Economic Recovery Tax Act of 1981. *Held*, petitioners are liable for the additions to tax under sec. 6659 for their 1978 and 1979 taxable years because the underpayments of tax for those years are attributable to valuation overstatements on the 1981 and 1982 returns.

David R. Brennan, for the petitioners.
Jack Forsberg, for the respondent.

OPINION

COHEN, *Judge*: This case is before the Court on petitioners' motion for partial summary judgment. The issue presented is whether section 6659[1] is applicable to underpayments for taxable years for which returns were filed prior to January 1, 1982, where such underpayments result from disallowance of carrybacks from taxable years for which returns were filed after December 31, 1981.

The material facts respecting this issue are not in dispute. Petitioners filed Federal income tax returns for 1978 and 1979 prior to January 1, 1982. In April of 1982, petitioners filed amended Federal income tax returns (Forms 1040X) for 1978 and 1979, claiming refunds for those years based on carrybacks of unused investment tax credit from 1981. The claimed refunds were paid in due course.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

In the notice of deficiency, respondent determined deficiencies for 1978, 1979, and 1981 based on disallowance of the investment tax credit and a loss claimed by petitioners in 1981 with respect to their participation in a master recording tax shelter. The deficiencies determined for 1978 and 1979 resulted from the disallowance of the investment tax credit carrybacks claimed from 1981. The total credit claimed was $75,000, which was allocated $27,440, $33,573, and $13,987, to 1981, 1978, and 1979, respectively.

In July of 1983, petitioners filed a second amended return (Form 1040X) for 1979 claiming an additional refund for 1979 based on the claimed carryback of investment tax credit from 1982. Respondent's amendment to answer raises an increased deficiency for 1979 based on the disallowance of the investment tax credit carryback claimed from 1982. In the amendment to answer, respondent also seeks additions to tax under section 6659 with respect to the deficiencies determined for 1978, 1979, and 1981 and the increased deficiency sought for 1979.

Petitioners agree that they are not entitled to the investment tax credit claimed in relation to the master recording activity in 1981, that there is an addition to tax under section 6659 for 1981, and that the "applicable percentage" of the underpayment is 15 percent. Petitioners also agree that if we decide the issue here adversely to them, section 6659 is otherwise applicable to their 1978 and 1979 taxes, and the "applicable percentage" of the underpayments is 15 percent. Although the carryback from 1982 has not yet been resolved, the same legal issue exists with respect to that item.

Section 6659(a) provides:

> SEC. 6659(a). ADDITION TO THE TAX.—If
>
> (1) an individual, or
>
> (2) a closely held corporation or a personal service corporation,
>
> has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

The amendment that added section 6659 to the Internal Revenue Code states that it "shall apply to returns filed after December 31, 1981." Sec. 722(a)(4), Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97-34, 95 Stat. 341.

Petitioners argue that the addition to tax does not apply to their 1978 and 1979 tax returns because they were filed before the effective date of section 6659. Petitioners' argument is premised on the assumption that the "return" referred to in subsection (a)(4) of section 722 of ERTA is the return for the year of the underpayment upon which the addition to tax for a valuation overstatement is imposed. Petitioners also argue that the 1978 and 1979 Forms 1040X filed after December 31, 1981, were merely claims for refund and thus do not constitute tax returns. Respondent contends that an underpayment attributable to a valuation overstatement on a return filed after December 31, 1981, is subject to the addition to tax irrespective of the filing date of the return for the year of the underpayment. We find respondent's position to be more persuasive in view of the statutory language, the legislative history, and the apparent deterrent purpose of section 6659.

Subsection (a) of section 6659 imposes an addition to tax where there is "an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement." Another pertinent portion of section 6659[2] provides:

> SEC. 6659(c). VALUATION OVERSTATEMENT DEFINED.—
>
> (1) IN GENERAL.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, *claimed on any return* is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be). [Emphasis supplied.]

Read in conjunction, subsections (a) and (c)(1) (now 6659(c)) provide that the addition to tax for valuation overstatements is applicable to underpayments attributable to property or adjusted basis having been overvalued or overstated on *any* return by more than 150 percent. If an underpayment is attributable to such an overvaluation or overstatement, the addition to tax is applicable regardless of whether the overvaluation or overstatement is made on the return for the year of the underpayment or whether it is made on a return for an earlier or later period.

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[2] Sec. 6659 was amended by the Deficit Reduction Act of 1984, sec. 155(c)(1)(A), Pub. L. 98-369, 98 Stat. 494, 693, to delete former sec. 6659(c)(2) and renumber as sec. 6659(c) the above provision, effective for returns filed after Dec. 31, 1984.

The House report and the House Conference report both state only that the provision applies to "returns filed after December 31, 1981." H. Rept. 97-201, at 244 (1981), 1981-2 C.B. 352, 398-399; H. Rept. 97-215 (Conf.), at 262 (1981), 1981-2 C.B. 481, 515. The General Explanation by the Staff of the Joint Committee on Taxation, however, describes the effective date as follows:

> *Effective Date*
>
> The provision applies to returns filed after December 31, 1981. Since the provision applies to returns tiled after December 31, 1981, property that has been overvalued on a return filed prior to that date may give rise to the penalty on a return filed after December 31, 1981, if the original overvaluation produces a tax underpayment on the later filed return (and if the property has not been held for more than five years as of the close of the taxable year). Moreover, the provision could be applicable in situations where overvaluations in one year result in carryovers to future years which give rise to underpayments in those years. This will be the case in any situation in which an overvaluation of property in one year produces a tax benefit in that year which, in turn, has the result of producing a tax benefit in a future year (or future years). [Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 335 (J. Comm. Print 1981).]

Accordingly, it seems that Congress contemplated and intended that the section apply at least in the following instances: (1) A return filed after the effective date including both an underpayment and a valuation overstatement; (2) a valuation overstatement on a return filed *before* the effective date and the related underpayment on a return filed after the effective date; and (3) a valuation overstatement on a return filed after the effective date and the related underpayment on a return filed subsequently. In each such case, the event, or the act of filing, that resulted in an underpayment attributable to a valuation overstatement took place after the effective date. Also, the actual underpayment of taxes occurred after the effective date.

Petitioners argue that because the committee explanation discusses only carryovers and not carrybacks, carrybacks must not have been intended. The circumstance present in this case, however, logically is a fortiori an appropriate one for application of section 6659. In the cases discussed in the committee explanation, the taxpayer is merely repeating or incorporating by reference a valuation overstatement made prior to the time that it was subject to a statutory sanction. Perhaps an explanation of how the sanction might apply in a carryforward situation was necessary to avoid uncertainty in that area. It is inconceivable to us, however, that Congress intended to leave a gap for those who would place a valuation overstatement on a return for a year after the effective date of section 6659, carry back the claimed benefit of the overstatement to prior years, and obtain a refund of taxes for the prior years free of the risk of the sanction obviously intended to deter such overstatements.

In other contexts, we have held that an item carried back from a later year to an earlier year, is "attributable to" the adjustment in the later year. *Herman Bennett Co. v. Commissioner*, 65 T.C. 506 (1975). That is the only reasonable interpretation of section 6659(a) in this case.

Based on the foregoing, we need not determine whether the Forms 1040X are "returns."

Petitioners' motion for partial summary judgment will be denied.

An appropriate order will be issued.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, CLAPP, SWIFT, JACOBS, GERBER, WRIGHT, PARR, and WILLIAMS, *JJ.*, agree with this opinion.

LARRY S. MAXWELL AND VICKEY L. MAXWELL, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 20641-85. Filed October 7, 1986.

Ps, Larry and Vickey, are partners in VIMAS, LTD., a limited partnership of more than 10 partners formed after Sept. 3, 1982. Larry is the general partner and the tax matters partner of VIMAS whose taxable year ends Dec. 31. R gave notice of the beginning of an administrative proceeding to audit VIMAS' 1982 partnership information return. On Apr. 25, 1985, R mailed Ps a statutory notice determining deficiencies for 1979, 1980, 1981, and 1982. In his notice for 1982, R disallowed Ps' claimed distributive shares of VIMAS' loss and investment tax credit, determined an addition to tax pursuant to sec. 6659 in respect of VIMAS' property and determined an addition to tax pursuant to sec. 6653(a), I.R.C. 1954. The deficiencies determined for 1979 and 1980 are attributable to carrybacks of the disallowed 1982 investment tax credit. An addition to tax pursuant to sec. 6659 was determined for 1979 and 1980 in respect of the carryback of the investment tax credit. An addition to tax pursuant to sec. 6653(a) was also determined for 1979 and 1980. The record is unclear on what, if any, portion of the deficiency determined for 1981 is attributable to Ps' interest in VIMAS. An addition to tax pursuant to sec. 6653(a) was determined for 1981. *Held*, the partnership audit and litigation provisions of the Code, viz secs. 6221-6233, apply to VIMAS' 1982 partnership taxable year. *Held, further*, Ps' distributive shares of VIMAS claimed loss and investment tax credit for 1982 are "partnership items." *Held, further*, Ps' carryback of the ITC to 1979 and 1980 is an "affected item." *Held, further*, the sec. 6659 addition to tax for 1979, 1980, and 1982 is an "affected item." *Held, further*, the sec. 6653(a) addition to tax to the extent its existence or amount is determinable by reference to a partnership adjustment is an "affected item." *Held, further*, the portion of a deficiency attributable to an affected item is a "deficiency attributable to a partnership item" within the meaning of sec. 6225(a). *Held, further*, we have no jurisdiction in a partner's personal tax case over any portion of a deficiency attributable to a partnership item.

Rodney L. Norville, for the petitioners.
Cheryl M.D. Rees, for the respondent.

OPINION

WILLIAMS, *Judge*: Respondent has filed a motion to strike certain items at issue in this case from the petition for lack of jurisdiction. This Court must decide whether we have jurisdiction over the portion of the deficiencies and the additions to tax determined by respondent for petitioners' 1979, 1980, 1981, and 1982 taxable years that arise out of certain adjustments of partnership items of income, deduction, or credit for the partnership taxable year ended December 31, 1982.

All of the facts have been stipulated and are so found. Petitioners are husband and wife who resided at Pasadena, Texas, at the time their petition was filed.

On April 4, 1985, respondent mailed a statutory notice of deficiency to petitioners determining deficiencies and additions to tax for their 1979, 1980, 1981, and 1982 taxable years. The deficiency for 1982 resulted, in part, from a disallowance of petitioners' distributive share of VIMAS, LTD.'s claimed loss and investment tax credit for the partnership's taxable year ended December 31, 1982. The deficiencies determined in petitioners' 1979 and 1980 taxable years result from the disallowance of investment tax carryback claimed by petitioners in 1982 as partners in VIMAS, LTD. It is unclear from the record what, if any, portion of the deficiency determined for 1981 results from petitioners' interest in VIMAS, LTD. An addition to tax pursuant to section 6659 was determined for 1979, 1980, and 1982 relating to the alleged overvaluation or overstated basis of VIMAS, LTD.'s partnership property. An addition to tax pursuant to section 6653(a)(2) determined for 1982 is identified in the statutory notice of deficiency as being attributable to petitioners' claimed tax benefits resulting from their interest in VIMAS, LTD. An addition to tax pursuant to section 6653(a)(2) was determined for 1981. An addition to tax was determined pursuant to section 6653(a) for 1979 and 1980 and pursuant to section 6653(a)(1) for 1981 and 1982.

VIMAS, LTD., was formed as a limited partnership under the laws of Texas on December 10, 1982. Petitioner Larry Maxwell was the general partner and 13 individuals, including Larry and petitioner Vickey Maxwell, were limited partners.

VIMAS, LTD., was formed to acquire, market, and exploit video game masters. The earliest that VIMAS, LTD. acquired video game master recordings and cassettes was December 10, 1982, when it executed leases pertaining to such properties. VIMAS, LTD.'s partnership information return (Form 1065) for 1982 states that it commenced operations on December 27, 1982.

Respondent commenced an administrative proceeding within the meaning of section 6224[1] and mailed to Larry notice of the beginning of the administrative proceeding on February 28, 1985. Larry is, within the meaning of section 6231(a)(7), the tax matters partner of VIMAS, LTD. On May 2, 1985, the required notice of the beginning of an administrative proceeding was mailed to each VIMAS, LTD., partner whose name and address had been furnished to respondent. See sec. 6223(a)(1). No notice of final partnership administrative adjustment ("FPAA") resulting from the administrative proceeding has, as yet, been mailed. On November 14, 1985, Larry executed a Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership (Form 872-P) on behalf of VIMAS, LTD.

This case presents an issue of first impression arising from the application of the partnership audit and litigation provisions of subchapter C of chapter 63 of subtitle F of the Internal Revenue Code of 1954, as amended. Respondent argues that certain adjustments that resulted in his determination of a portion of the deficiency for 1982 were "partnership items" within the meaning of section 6231(a)(3).[2] In respondent's view, this Court has jurisdiction over these items only if they are raised in a petition filed subsequent to the issuance of the FPAA pursuant to the procedures of section 6226 and Rules 240 et seq.[3] Sec. 6230(1). Petitioners counter that dismissal of their claims for redetermination of the portions of the deficiencies attributable to their interest in VIMAS, LTD., and related additions to tax would be prejudicial to them. Petitioners claim that they had reached a basis for settlement of all issues in their case and that the dismissal urged by respondent adversely affects this settlement.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, unless otherwise indicated.

[2] SEC. 6231. DEFINITIONS AND SPECIAL RULES.

(a) DEFINITIONS—For purposes of this subchapter—

* * * * * * *

(3) PARTNERSHIP ITEM.—The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

[3] All Rule references are to the Tax Court Rules of Practice and Procedure.

This case presents the dichotomy between, on the one hand, the procedures applicable to the determination and redetermination of *deficiencies* and, on the other hand, the procedures applicable to the administrative adjustment and judicial readjustment of *partnership items.* Prior to the enactment of the partnership audit and litigation provisions, no dichotomy existed. Any deficiency determination that involved items of income, loss, deduction, or credit of a partnership was made for each partner in conjunction with determining the proper tax treatment of all other items on his individual Federal income tax return. Judicial review of respondent's deficiency determination considered only the case of the particular partner before the court. Each partner's tax liability was determined independently of what any other partner's tax liability in respect of identical items might have been. As noted by the Conference report accompanying the Tax Equity and Fiscal Responsibility Act of 1982, H. Rept. 97-760, 97th Cong. 2d Sess., at 599, certain unavoidable consequences follow from separately determining each partner's tax liability:

> adjustments are made to each partner's income tax return at the time that return is audited. A settlement agreed to by one partner with the Internal Revenue Service is not binding on any other partner or on the Service in dealing with other partners. Similarly, a judicial determination of an issue relating to a partnership item generally is conclusive only as to those partners who are parties to the proceeding. [H. Rept. 97-760 (Conf.), *supra*, 1982-2 C.B. at 662.]

By enacting the partnership audit and litigation procedures, Congress provided a method for uniformly adjusting items of partnership income, loss, deduction, or credit that affect each partner. Congress decided that no longer would a partner's tax liability be determined uniquely but "the tax treatment of any partnership item [would] be determined at the partnership level." Sec. 6221.

In drawing the line between those matters which may be the subject of a partnership proceeding and those which may not be, the statute divides disputes arising from "partnership items" from disputes arising from "nonpartnership items." Compare paragraphs (3) and (4) of section 6231(a). If the tax treatment of a "partnership item" is at issue, the statute requires the matter to be resolved at the partnership level. Sec. 6221. Respondent has no authority to assess a deficiency attributable to a partnership item until after the close of a partnership proceeding (sec. 6225(a)), and may be enjoined from making premature assessments. Sec. 6225(b). Special rules apply to settlement agreements. Sec. 6224(c). Special statutes of limitations apply to assessment of deficiencies attributable to partnership items. Sec. 6229. In separating partnership adjustments from the deficiency procedures applicable in all other income tax matters, Congress intended that all nonpartnership matters on a partner's Federal income tax return continue to be subject to the existing rules for administrative and judicial resolution of the partner's tax liability. As reported by the Conference report, H. Rept. 97-760, at 611:

> Existing rules relating to administrative and judicial proceedings, statutes of limitations, settlements, etc., will continue to govern the determination of a partner's tax liability attributable to nonpartnership income, loss, deductions, and credits. Neither the Secretary nor the taxpayer will be permitted to raise nonpartnership items in the course of a partnership proceeding nor may partnership items, except to the extent they become nonpartnership items under the rules, be raised in proceedings relating to nonpartnership items of a partner. [1982-2 C.B. at 668.]

It is evident both from the statutory pattern and from the Conference report that Congress intended administrative and judicial resolution of disputes involving partnership items to be separate from and independent of disputes involving nonpartnership items. Consequently, the portion of any deficiency attributable to a "partnership item" cannot be considered in the partner's personal case involving other matters that may affect his income tax liability. The "partnership items" must be separated from the partner's personal case and considered solely in the partnership proceeding. See sec. 6226(a); sec. 6226(f).

This Court's Rules follow this statutory pattern. Rule 240(b)(2) defines "partnership action," in part, as "an 'action for adjustment of partnership items' under Code Section 6228." Rule 240(c) states that [this] "Court does not have jurisdiction of a partnership action" if no FPAA has been issued. See Rule 240(c)(1)(i).

It is certain on this record that the partnership audit and litigation provisions apply to this case. Sections 6221 et seq. are "applicable to partnership taxable years beginning after September 3, 1982" and "to any partnership taxable year ending after September 3, 1982, if the partnership, each partner, and each indirect partner requests such application and the Secretary or his delegate consents to such application." Sec. 402(a), Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 648. The consent provision of this effective date rule is not applicable in this case because VIMAS, LTD.'s first partnership taxable year commenced after September 3, 1982.[4] VIMAS, LTD., a partnership of more than 10 partners that was formed on December 10, 1982, was a partnership within the meaning of section 6231(a)(1). VIMAS, LTD. acquired its operating partnership property on December 10, 1982, and commenced operations in December 1982. As a result, adjustments to VIMAS, LTD.'s items of partnership income, loss, deduction, or credit, such as those at issue in this case, are subject to the partnership audit and litigation provisions.

In this case, no FPAA has been issued to VIMAS, LTD. Because the issuance of an FPAA is a condition precedent to the exercise of our jurisdiction over a partnership action, it follows that we have no jurisdiction in this case to redetermine any portion of a deficiency attributable to a "partnership item." We must, therefore, decide whether any of the items giving rise to any part of the deficiencies in this case are "partnership items."

Section 6231(a)(3) provides that a "partnership item" means any item required to be taken into account for the partnership's taxable year to the extent prescribed by respondent's regulations as an item that "is more appropriately determined at the partnership level than at the partner level." Partnership losses or credits are items taken into account by VIMAS, LTD., for the 1982 partnership taxable year. Cf. *Southern v. Commissioner*, 87 T.C. 49 (1986); section 301.6231(a)(3)-1(a)(1)(i), Proced. & Admin. Regs., provides that "Items of * * * loss, deduction, or credit of the partnership" are more appropriately determined at the partnership level. VIMAS, LTD.'s partnership loss for 1982 and VIMAS, LTD.'s investment tax credit for 1982 are, therefore, "partnership items" unless some provision of the statute transmutes them into "nonpartnership items." See secs. 301.6231(a)(3)-1(a)(1)(i) and (vi)(A), Proc. & Admin. Regs.

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[4] While it is true that VIMAS, LTD.'s first taxable year ended after Sept. 3, 1982, it is also true that every one of its taxable years will end after Sept. 3, 1982. To construe the effective date rule as applying the consent requirement to all taxable years ending after Sept. 3, 1982, without limiting it to those years that began before Sept. 4, 1982, would result in applying the consent requirement to all future years of all partnerships. The Conference report states that the partnership audit and litigation provisions are mandatory except for that narrow class of partnership years that do not begin after Sept. 3, 1982.

On this record it is clear that respondent has given notice of the beginning of the administrative proceeding. Consequently, section 6223(a)(1) has been satisfied and none of the other events that could cause a transmutation of "partnership items" into "nonpartnership items" has occurred. Sec. 6231(b)(1).[5] It follows that the VIMAS, LTD., loss and investment tax credit are "partnership items" and that we lack jurisdiction over deficiencies attributable to those partnership items.

The carryback of VIMAS, LTD.'s investment tax credit that results in the deficiencies for petitioners' 1979 and 1980 taxable years is not a "partnership item." Although the existence or amount of the carryback cannot be determined without reference to the VIMAS, LTD., investment tax credit to which VIMAS, LTD., partners were entitled for 1982, the amount of credit to be carried back is not a "partnership item" because a partnership does not take into account any carryback for any taxable year. Rather, the carryback is peculiar to each partner's own tax posture. The carryback is, however, an "affected item" since its existence or amount is "affected by" the investment tax credit that is a partnership item. Sec. 6231(a)(5). An item whose existence or amount is dependent on any partnership item is an affected item. See H. Rept. 97-760 (Conf.), *supra* at 609, 1982-2 C.B. at 667. As an affected item, however, the carryback gives rise to deficiencies for petitioners' 1979 and 1980 years that are attributable to the partnership item which is the claimed investment tax credit for 1982. Because the carrybacks are the only items giving rise to the deficiencies at issue for 1979 and 1980, we lack jurisdiction over the deficiencies determined for those years.[6]

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[5] SEC. 6321. DEFINITIONS AND SPECIAL RULES.

(b) ITEMS CEASE TO BE PARTNERSHIP ITEMS IN CERTAIN CASES.—

(1) IN GENERAL.—For purposes of this subchapter, the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date—

(A) the Secretary mails to such partner a notice that such items shall be treated as nonpartnership items,

(B) the partner files suit under section 6228(b) after the Secretary fails to allow an administrative adjustment request with respect to any of such items,

(C) the Secretary enters into a settlement agreement with the partner with respect to such items, or

(D) such change occurs under subsection (e) of section 6223 (relating to effect of Secretary's failure to provide notice) or under subsection (c) of this section.

An addition to tax has been determined for 1979, 1980, and 1982 pursuant to section 6659 which, in this case, relates solely to VIMAS, LTD.'s partnership property. Although the basis or value of partnership property is a partnership item, the section 6659 addition to tax is not an item "required to be taken into account for the partnership's taxable year." It is, therefore, not a partnership item. The existence or amount of this addition to tax, however, depends on a finding of proper basis or value of VIMAS, LTD.'s property. Consequently, it is an affected item.

The addition to tax for negligence in 1979, 1980, 1981, or 1982 may have been determined because of either the partnership's tax reporting positions or the partner's own tax reporting positions. The partnership's reporting positions will be exclusively the subject of the partnership action while the partner's reporting positions, except for positions consistent with the partnership's (sec. 6222(b)), will be the subject of the partner's personal case. A finding of negligence in either the partnership action or the partner's personal case will affect the other. The 5-percent addition (whether pursuant to section 6653(a) for 1979 and 1980 or pursuant to section 6653(a)(1) for 1981 and 1982) is applied to the entire deficiency for the year. Consequently, if the partner was negligent in his own reporting positions, any deficiency attributable to partnership items will also bear that 5-percent addition. Likewise, if the partnership's reporting positions resulted from negligence, the 5-percent addition would apply also to the portion of any deficiency attributable to nonpartnership items.

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[6] See sec. 6229(a) which extends the period of limitations for assessments of tax "attributable to any partnership item (or affected item)." As discussed *infra*, a deficiency attributable to an affected item such as a partner's carryback of a partnership's investment tax credit is also a "deficiency attributable to a partnership item." Assessments of such deficiencies can be made only at the conclusion of the partnership proceeding in which readjustments to the partnership items giving rise to the deficiencies are determined. Sec. 6225(a).

Certain complications in applying section 6653 to the entire deficiency for a year result, however, from following the separate partnership audit and litigation procedures. As discussed above, Congress intended that partnership tax issues be resolved without hindering, and without hindrance from, the resolution of nonpartnership tax issues. If a decision of deficiency in tax is entered in a partner's personal tax case without a finding of negligence while the partnership action is pending, any 5-percent addition due to the negligence of the partnership cannot be part of that decision. Similarly, if a finding of negligence is made in the partner's personal case, the addition to tax will increase if an additional deficiency results from the partnership action. It appears that the resolution of this complication is found in treating [illegible] affected item" (1) any addition to tax for negligence [illegible] partnership action or (2) where negligence is found in the personal case, any increased addition to tax on a deficiency resulting from partnership adjustments.

Affected items depend on partnership level determinations, cannot be tried as part of the personal tax case, and must await the outcome of the partnership proceeding.[7] Apparently, in these circumstances, respondent may issue a second notice of deficiency to the partner determining an additional deficiency attributable to "affected items."[8] In other circumstances, a computational adjustment is made.[9]

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[7] An item, such as a medical expense deduction, the deductibility of which depends on adjusted gross income, may or may not be affected by partnership adjustments. A medical expense deduction would be a nonpartnership item, the partner's entitlement to which would be litigated in the partner's personal case. The deduction may be limited (or increased) by a partnership adjustment and to that extent only it would be an affected item. The proper tax liability attributable to such an affected item would be the subject of a computational adjustment (see note 9 below).

[8] Sec. 1875(d), Tax Reform Act of 1986, Pub. L. 99-514; see also Proposed Income Tax Regs. sec. 301.6231(a)(6)-1(c), 51 Fed. Reg. 13245 (Apr. 18, 1986).

[9] SEC. 6231. DEFINITIONS AND SPECIAL RULES.

(a) DEFINITIONS.—For purposes of this subchapter—

* * * * * * *

(6) COMPUTATIONAL ADJUSTMENT.—The term "computational adjustment" means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter to an indirect partner shall be treated as computational adjustments

See also sec. 6230.

As an "affected item," the addition to tax for negligence resulting from partnership reporting positions cannot be an issue joined in a partner's personal tax case because a deficiency determined by reference to such an affected item requires a partnership level determination—i.e., whether the partnership reported partnership items negligently. Such affected items cannot be considered in the course of deciding petitioners' personal case without trespassing the line of demarcation drawn by Congress between the audit and litigation of partnership tax matters and the resolution of all other tax items of the partner. Any other principle would inextricably tie the two together and remove the statutory dichotomy whenever an addition to tax affected by partnership items has been determined by respondent.

Consequently, the VIMAS, LTD., partnership items and affected items that are presently raised in the petition in this case will be struck from the petition for lack of jurisdiction. Nevertheless, respondent is barred from assessing the deficiencies and additions to tax for 1979 and 1980 and those portions of the deficiencies for 1981 and 1982 and related additions to tax attributable to partnership items (including any portion calculated by reference to affected items) prior to the termination of the partnership proceeding. The statute of limitations, of course, does not run on the deficiencies attributable to partnership items (including affected items). Sec. 6229(a).

The collapse of the settlement that petitioners believed they had constructed is unfortunate, but we may not take jurisdiction except where the statute mandates it.

An appropriate order will be entered.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, GERBER, WRIGHT, and PARR, *JJ.*, agree with this opinion.

LAWRENCE LEVY AND ROCHELLE LEVY, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 31285-81, 234-82, 27133-82, 5553-84, 34739-84. Filed October 20, 1986.

The instant cases were set for trial on numerous occasions and continued. Petitioners never stipulated any facts with respondent and, despite warnings from the Court, never prepared for trial. *Held*, the cases are dismissed for failure properly to prosecute under Rule 123(b) of the Court's Rules of Practice and Procedure.

Steven S. Saber, for the petitioners.
Bonnie L. Rosner, for the respondent.

OPINION

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioners' Federal income tax as follows:

Docket No.	*Taxable year*	*Deficiency*
31285-81	1977	$25,400
	1978	13,767
	1979	10,135
234-82	1979	21,908
27133-82	1980	29,582
5553-84	1981	11,590
34739-84	1975	2,844
	1976	4,106
	1977	8,347
	1978	22,294
	1979	2,324
	1980	7,027

These cases were called for trial at the call of the calendar in Miami, Florida, on February 24, 1986. That was the beginning date of a 2-week trial session in Miami. Parties in other cases scheduled for trial previously contacted the Court to ask for dates certain due to the number of witnesses and the lengthy trials they anticipated. Those other cases were, therefore, set for trial during the second week, leaving available only the first week to set the instant group of cases for trial, except for the testimony of witness Robert Phaneuf, who was scheduled to testify on March 3, 1986. At the calendar call, counsel for petitioners announced that he was not prepared to proceed to trial the first week. After holding two hearings, the Court announced that, because petitioners were not prepared, they had failed properly to prosecute their cases and that they would be dismissed under Rule 123(b).[2]

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[1] Upon the Court's motion the following cases are consolidated for opinion only: Lawrence Levy and Rochelle Levy, docket No. 31285-81; Stephen G. Reich and Shyla Reich, docket No. 234-82; Stephen G. Reich and Shyla Reich, docket No. 27133-82; Stephen G. and Shyla Reich, docket No. 5553-84; Norman Kaye and Cheryl J. Kaye, docket No. 34739-84.

On March 26, 1986, the Court received from petitioners motion to set aside dismissal and reinstate Tax Court cases on the Tax Court calendar. On April 10, 1986, the Court received respondent's objection to petitioners' motion.

The Court has considered the entire record in this group of cases, including petitioners' motion and respondent's objection, described above, and concludes that it was appropriate to dismiss the cases when they were called for trial.

These cases, all of which involve the identical issue, have been at issue since the following dates:

Docket No.	*Date at issue*
31285-81	May 3, 1982
234-82	Feb. 25, 1982
27133-82	Jan. 14, 1983
5553-84	Apr. 10, 1984
34739-84	Nov. 29, 1984

On September 21, 1983, the Court served notices of trial on the parties in docket Nos. 31285-81, 234-82, 27133-82, setting those cases for trial on December 5, 1983. On November 14, 1983, respondent filed motions for continuance in which he represented that counsel for petitioners had no objection. The Court granted respondent's motions on November 15 and 17, 1983. On November 14 and 18, 1983, the then counsel for petitioners filed motions to withdraw from the cases set for trial. In his motions he alleged that his clients advised him that they had retained new counsel. In addition, he alleged that he advised his clients as follows: (1) That new counsel should immediately file appearances with the Court; (2) that Judge Whitaker, the trial judge for the Miami trial session commencing on December 5, 1983, would not grant any delay in order to engage new counsel; (3) that a list of witnesses and stipulations should be prepared promptly in accordance with directions issued by Judge Whitaker; (4) that petitioners should deliver a copy of the letter of directions written by Judge Whitaker to new counsel in order that new counsel could immediately comply with its provisions; and (5) that petitioners should have their cases ready to try on December 5, 1983, or such other time as the Court announces. On November 17 and 21, 1983, the Court granted the motions to withdraw as counsel. On December 7 and 8, 1983, present counsel entered his appearances.

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[2] Unless otherwise indicated, all Rule references are to the Rules of Practice and Procedure of this Court.

On July 2, 1984, the Court served upon the parties in docket Nos. 31285-81 and 234-82 notices of trial setting those cases for trial on September 17, 1984. When the cases were called for trial at the calendar call, counsel for petitioners advised the Court that the parties would get the related cases (the other three cases herein) together for trial. The Court directed counsel for petitioners to furnish a list of related cases within 60 days. The Court then continued the cases.

On December 31, 1984, the Court served a notice setting docket No. 5553-84 for trial on March 11, 1985. On January 22, 1985, respondent filed a motion for order compelling petitioners to produce certain documents. On January 28, 1985, petitioners moved to continue docket No. 5553-84 from the trial session of March 11, 1985, in order to consolidate all of the cases, for the reason that petitioners' expert witness could not testify during the week of March 11, 1985, and that petitioners' certified public accountant had commitments to some corporate clients and would not be available until after March 18, 1985.

On February 4, 1985, petitioners, in docket No. 5553-84 asked for an additional 30 days to assemble documents in response to respondent's motion to compel production of documents.

On February 27, 1985, the Court served an order on the parties in docket No. 5553-84, continuing the case from the March 11, 1985, session to the session commencing on June

3, 1985. On March 11, 1985, the Court served the parties in all of these cases with notices of trial, setting the cases for trial on June 3, 1985. Later, the cases were continued generally from the trial session set for June 3, 1985.

On August 28, 1985, the Court served on counsel for petitioners in all of these cases, notice setting case for trial in Miami on January 13, 1986. That notice provided, in part, that "The calendar for that Session will be called at 10:00 a.m. on that date and both parties are expected to be present at that time *and be prepared to try the case.*" (Emphasis added.) In addition, it provides:

> Your attention is called to the Court's requirement that, if the case cannot be settled on a mutually satisfactory basis, the parties, *before trial*, must agree in writing to *all* facts and *all* documents about which there should be no disagreement. Therefore, the parties should contact each other promptly and cooperate fully so that the necessary steps can be taken to comply with this requirement. YOUR FAILURE TO COOPERATE MAY ALSO RESULT IN DISMISSAL OF THE CASE AND ENTRY OF DECISION AGAINST YOU.

The Court directed the Clerk of the Court to mail with the notice setting case for trial, a memorandum which provided in part as follows:

> In the interest of an orderly and efficient disposition of the trial calendar, Judge Goffe has directed that all settlement stipulations and stipulations of facts in cases which are to be tried be ready for filing at the call of the calendar on Monday morning, January 13, 1986, at 10:00 a.m. * * *
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> In accordance with Rule 91 of the Court's Rules, all facts are to be stipulated to the maximum extent possible. Judge Goffe expects all written evidence to be stipulated, except where a question of authenticity is involved or the written evidence is to be used to impeach the credibility of a witness. Objections on the ground of materiality or relevancy may be reserved in the stipulation. * * *
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> In addition Judge Goffe directs that counsel in those cases which are expected to be tried submit trial memoranda at the calendar call. The trial memoranda should outline the issues involved; the witnesses to be called, if any; the nature of the testimony which each witness is expected to give in sufficient detail to provide a clear understanding of the case; and a law and argument section setting forth the primary legal authority on which the party relies. If questions of the admissibility of evidence are anticipated, these should be covered in the trial memorandum. * * *

> If the case involves expert testimony covered by a report of an expert witness which is expected to be introduced into evidence, Judge Goffe expects the parties to comply with Rule 71(d)(2) of the Court's Rules. In addition, all exhibits and underlying documents to be introduced as part of the testimony of expert witnesses will be exchanged by the parties prior to trial. The opinion of the expert witness and the basis for his opinion shall be presented primarily in written form and the oral testimony of the expert witness shall be kept to a minimum. The opposing party will be given full opportunity to cross-examine the expert witness without regard to the scope of the witness' direct examination. The reports of expert witnesses are not "filed" with the Court until the case is tried; therefore, motions for extensions of time for complying with Rule 71(d)(2) are not appropriate. Any problems encountered in connection with complying with Rule 71(d)(2) should be handled informally directly with Judge Goffe.
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> Judge Goffe will be available on Monday after the call of the calendar for conference with the parties in any case set on the trial calendar to assist in the stipulation of facts, trial procedures (including rulings on evidence), and any other matters that may expedite disposition. Cases will, however, be set for trial on Monday, if time permits. If counsel anticipate trial problems, they are encouraged to arrange a conference call with opposing counsel and Judge Goffe at his chambers in Washington, D.C., * * * as early as such problems become apparent. * * *

On November 29, 1985, respondent filed a motion to continue for the purpose of stipulating facts with petitioners in order to narrow the issues and to shorten the trial time. Counsel for petitioners agreed with the motion. The motion also asked that the cases be set for trial on February 24, 1986. The Court granted that motion on December 4, 1985.

On January 30, 1986, the Court received and filed respondent's motion to take testimony of witness on Monday, March 3, 1986. In respondent's motion, he alleged that Mr. Phaneuf was on the high seas and could appear only on that date. Respondent also alleged that counsel for petitioners objected to granting the motion because it would be taking the testimony out of turn.

On February 3, 1986, petitioners filed motion to continue and to calendar. The grounds for continuance alleged by petitioner were that a witness, Marvin Popkin, was hospitalized and could not testify, all of which would be confirmed by a letter from a doctor to be supplied later. Mr. Popkin was the promoter of the tax shelter involved in these cases. Petitioners also alleged that counsel for petitioners had a schedule conflict that would prevent him from appearing at the February 24, 1986, trial session. Attached to the motion was an order of the U.S. District Court filed January 24, 1986, setting a matter for trial on February 24, 1986, and a calendar call for February 21, 1986. The motion contained no request for a date for which the cases should be calendared.

The parties and the Court had a telephone conference call on February 3, 1986, to discuss the two motions. At that time the Court directed counsel for petitioners to express mail to the Court the statement of Mr. Popkin's doctor.

Respondent filed objection to petitioners' motion to continue, in which he alleged that Mr. Popkin's doctor advised counsel for respondent that Mr. Popkin would be able to testify in 3 weeks, or February 24, 1986, the date of the calendar call. Respondent attached to his objection to petitioners' motion an affidavit of a revenue agent who visited Mr. Popkin. As explained later, Mr. Popkin appeared in Court at the calendar call.

The Court and counsel for the parties held another conference call on February 7, 1986. The Court asked counsel for petitioners why he had not sent the doctor's statement to the Court and he replied that the medical information was being "indexed."

Rule 134 provides that conflicting engagement of counsel or employment of new counsel ordinarily will not be regarded as ground for continuance. It also provides that "A motion for continuance, filed 30 days or less prior to the date to which it is directed * * * will be deemed dilatory and will be denied unless the ground therefor arose during that period or there was good reason for not making the motion sooner."

Petitioners' motion for continuance was received by the Court on February 3, 1986, which was less than 30 days prior to February 24, the date set for trial, yet the attachment to the motion indicated that counsel for petitioners was advised on January 24, 1986, that the other matter was set for trial in the District Court. Petitioners' motion for continuance was, therefore, obviously dilatory.

Counsel for petitioners also failed to promptly send th Court the doctor's statement as he had promised. Therefore on February 12, 1986, the Court denied petitioners' motio for continuance. In both of the conference calls with th parties on February 3, 1986, and February 7, 1986, th Court warned counsel for petitioners that the cases woul be tried in Miami during the trial session commencing o February 24, 1986, and he should immediately proceed t stipulate facts with counsel for respondent. He completel ignored the warning of the Court and made no attemp whatever to stipulate facts or to otherwise prepare for trial He filed no trial memorandum as required by our memoran dum quoted above.

On February 18, 1986, petitioners filed motion for recon sideration for continuance together with affidavits from doctors of Mr. Popkin. The motion also contained a allegation that petitioners intended to call 20 witnesses, a fact which counsel for petitioners never reiterated at the February 24, 1986, calendar call or the subsequent hearin immediately following the calendar call.

The motion also alleged that, "The Respondent's attorneys have not stipulated to any documentation presented to them over the last six (6) months and it will take at least a week to get all the records necessary for this trial to be admitted and stipulated in evidence."

At the calendar call counsel for petitioners explained this allegation by stating that he asked counsel for respondent to stipulate to all of the documents that "she had seen" pursuant to a discovery request she served upon him. Counsel for respondent stated that she was unable to recall the specific documents she had seen. As will be explained later, counsel for petitioners refused to stipulate any facts which counsel for respondent delivered to him on February 14, 1986, the day after he certified as having mailed the motion to the Court.

The motion for reconsideration for continuance was denied on February 18, 1986.

The cases involve a lithograph tax shelter and the primary issue is the valuation of the lithograph. Respondent, in compliance with Rule 71(d)(2)[3] submitted to the

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[3] Rule 71(d)(2), in effect until July 1, 1986, has been superseded by Rule 143(f).

Court and served upon counsel for petitioners the reports of three expert witnesses who were to testify as to the value of the lithograph. Petitioners have never submitted or served an expert report. When petitioners moved for a continuance in docket No. 5553-84 on January 28, 1985, counsel for petitioners represented to the Court that their expert witness was unable to testify during the week of March 11, 1985. Petitioners, however, have never complied with Rule 71(d)(2) which requires submission to the Court and service upon respondent of an expert report 15 days prior to trial. This failure leads to the conclusion that petitioners have never employed an expert witness. Further continuances based upon petitioners' lack of preparation would give petitioners an unfair advantage over respondent in view of the filing of the expert reports.

When the cases were called for trial at the calendar call on February 24, 1986, counsel for petitioners reported that the evidence in petitioners' case consisted only of the testimony of Marvin Popkin and documents alleged to be in his possession. Mr. Popkin appeared at the calendar call, explained his alleged physical condition, and also stated that if he were called as a witness he would likely refuse to testify on Fifth Amendment grounds. Counsel for petitioners had no information as to whether his witness, Mr. Popkin, was a target of criminal prosecution.

Counsel for respondent represented to the Court at the calendar call that she had assembled relevant documents together with a stipulation of facts and delivered them to counsel for petitioners more than 10 days prior to the calendar call. Counsel for petitioners never disputed that representation.

Counsel for respondent represented to the Court at the calendar call that she had 18 witnesses who were ready to testify. She estimated the trial time to be 2½ to 3 days. At the calendar call, the Court announced that the case would probably be set for Wednesday, February 26, 1986, and then recessed in order to arrange the calendar of all the cases to be set for trial. At the subsequent hearing immediately following the calendar call, it was made clear that petitioners, who have the burden of proof, had never submitted a stipulation of facts to respondent.

Petitioners, in their motion to set aside dismissal a reinstate Tax Court cases on the Tax Court calenda alleged that counsel for petitioners was surprised at t calendar call that Marvin Popkin intended to refuse testify, if called as a witness, relying upon his Fift Amendment rights. Despite counsel's assertion at th calendar call that he could not proceed to trial without th testimony of Mr. Popkin, he alleged in his motion that h could establish the "commercial valuation" of the shelte package by certain facts, none of which he had eve submitted to respondent for stipulation. He further allege that he could not stipulate to any "documentation" provided by respondent because he had not had the opportunity to see the "documentation" prior to that date. Respondent's counsel disputed this allegation by submitting a cop of a transmittal letter from her to petitioners' counse enclosing the stipulation of facts and exhibits, the receipt o which is acknowledged by petitioners' counsel. We find th allegation of petitioners' counsel to be untrue based upo the record before us. In her letter, counsel for responden set a conference for February 19, 1986, for stipulating fact and petitioners' counsel not only failed to attend but als refused to reschedule the conference at any time. Ye counsel for petitioners alleged in his motion "That thi motion for reconsideration for continuance is not being submitted for the purpose of delay in this matter but only for medical reasons, and to get the Respondent to stipulate to documentation and no prejudice will result to any of the parties herein." In view of the lack of cooperation o petitioners' counsel with respondent's counsel and his failure to follow the direct warnings of the Court in the telephone conference calls, the Court finds the foregoing allegation incredible. Counsel for petitioners was woefully unprepared after having totally disregarded the Court's Rules and our direct warnings to him on February 3, 1986, and February 7, 1986.

When Mr. Popkin appeared before the Court on February 24, 1986, he was alert and aggressive. Based upon our observation of him and his raising the possibility of invoking his Fifth Amendment rights for the first time, the

Court concludes that he was lying about his physical condition and that he was physically able to testify.

Dismissal of a case is a sanction resting in the discretion of the trial court. *Durgin v. Graham*, 372 F.2d 130, 131 (5th Cir. 1967).[4] The Court exercised its discretion and dismissed a case under Rule 123(b) for failure properly to prosecute in *Freedson v. Commissioner*, 67 T.C. 931 (1977), affd. 565 F.2d 954 (5th Cir. 1978). That case constitutes precedent in the 11th Circuit, the circuit to which an appeal in the instant case would lie, for the facts in the instant case are not materially different from the facts in *Freedson* where it was held that Rule 123(b) requires the Court to balance potentially rival considerations: the policy of having cases heard on their merits and the policy of avoiding harassment to the defending party arising from unjustifiable delay.

In addition, the Court must consider the effect of delay upon the Court. The effect of delay on the Court was explained in *Brooks v. Commissioner*, 82 T.C. 413, 429-430 (1984), affd. without published opinion 772 F.2d 910 (9th Cir. 1985):

> The imposition on the Court is also a matter to be considered. Our well-publicized case load is attributable not merely to protesters and tax shelters, but also to parties in other types of cases who depend upon obfuscation and delay to postpone or discount their liabilities. The Office of the Court is in Washington, D.C., but trial sessions are held in various cities, including * * * for the convenience of the parties. Secs. 7445, 7446; Rules 10, 140. When cases are at issue, they are scheduled on the next available calendar in the place requested for trial, generally in order of filing, and notice of trial is sent. See Rule 132. The judge, trial clerk, and reporter are assigned, and the courtroom space is reserved. When a case set for trial is not resolved during a trial session in which time has been set aside for it, a substantial waste of the Court's resources results.
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> Delays also affect other taxpayers who are awaiting the opportunity to have their cases heard. Only a certain number of cases can be placed on any particular trial calendar. Each time that a case scheduled for trial does not proceed, time is wasted that could have been spent on other cases if they could have been scheduled. Respondent's counsel is required to spend time preparing cases for trial which could be spent working with taxpayers on other cases and attempting to settle them. These unnecessary burdens on the system are unreasonable and unfair from the

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[4] The Court of Appeals for the 11th Circuit has announced that it will follow the precedent of the Court of Appeals for the 5th Circuit as it existed on Sept. 30, 1981. *Bonner v. City of Prichard, Alabama*, 661 F.2d 1206 (11th Cir. 1981).

> standpoint of everyone involved. See *Montgomery v. Commissioner*, *supra*; see also *Hatfield v. Commissioner*, 68 T.C. 895, 899 (1977).
> [*Brooks v. Commissioner*, *supra* at 429-430; fn. ref. omitted.]

It is recognized that dismissal is a sanction of last resort, not to be used indiscriminately, but it is also recognized that here, as in other areas of the law, this sanction must be available to the Court in appropriate cases. Its purpose is not only to penalize those whose conduct warrants the sanction but also to deter others who might be tempted to engage in like conduct. *Dusha v. Commissioner*, 82 T.C. 592, 605 (1984).

For the reasons set forth above, petitioners' motion to set aside the dismissal of the instant case is denied.

Appropriate orders and decisions will be entered.

NICK DELUCIA, JR., AND MADELINE A. DELUCIA, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22090-83. Filed October 20, 1986.

At an earlier stage in the instant case, the Court granted respondent's motion for summary judgment in entirety as to petitioner-husband, and in part as to petitioner-wife. As a result, the only substantive issue remaining is petitioner-wife's claim of "innocent spouse" status under sec. 6013(e), I.R.C. 1954. Respondent moved to compel deposition of petitioner-husband under Rule 75, Tax Court Rules of Practice and Procedure, contending that, because of the summary judgment order, petitioner-husband is no longer a party in the instant case. *Held*: Rule 75 applies only to nonparty witnesses. Petitioner-husband still is a party in the instant case. Rule 75 does not permit respondent to depose petitioner-husband. Respondent's motion is denied.

James K. O'Malley, for the petitioners.
Edward F. Peduzzi, Jr., for the respondent.

OPINION

CHABOT, *Judge*: This matter is before us on respondent's motion to compel deposition of petitioner Nick DeLucia, Jr., under Rule 75.[1]

Respondent determined deficiencies in Federal individual income taxes against petitioners for 1974, 1975, and 1976, in the amounts of $1,820.39, $35,190.29, and $1,635.00, respectively. Respondent also determined that petitioner Nick DeLucia, Jr. (but not petitioner Madeline A. DeLucia), is liable for additions to tax under section 6653(b)[2] (fraud, etc.) in the amounts of $910.20, $17,595.15, and $817.50 for these years. On April 17, 1985, this Court ordered, in response to respondent's motion for summary judgment filed April 3, 1985: (1) That respondent's motion is granted insofar as it relates to petitioner Nick DeLucia, Jr.; (2) that respondent's motion is granted insofar as it relates to petitioner Madeline A. DeLucia, in that it is established that there are deficiencies in income tax for the years and in the amounts set forth in the statutory notice of deficiency, that some part of each of these deficiencies is due to the fraud of petitioner Nick DeLucia, Jr., that the statute of limitations is not a bar to the assessment of any of these deficiencies, and that petitioners failed to report income on their tax returns for the years in the amounts and from the sources referred to in respondent's request for admissions, and (3) that respondent's motion is denied, but only insofar as it seeks to preclude petitioner Madeline A. DeLucia from further contending that she is entitled to relief under section 6013(e) (innocent spouse rule) from liability for any part or all of the deficiency for each of the years in issue.

The issues for decision on respondent's motion to compel deposition are as follows:

(1) Whether petitioner Nick DeLucia, Jr., is a nonparty witness for purposes of Rule 75, in view of the fact that the order granting partial summary judgment resolves all issues against this petitioner, and

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[1] Unless indicated otherwise, all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Unless indicated otherwise, all section references are to sections of the Internal Revenue Code of 1954 as in effect for the years in issue. See note 7 *infra*.

(2) If petitioner Nick DeLucia, Jr., is a nonparty witness for purposes of Rule 75, then whether respondent's motion to compel deposition should be granted on grounds that the use of this "extraordinary method of discovery" is warranted in the instant case.

When the petition was filed in the instant case, petitioner Nick DeLucia, Jr. (hereinafter sometimes referred to as Nick), resided in Montgomery, Pennsylvania, and petitioner Madeline A. DeLucia (hereinafter sometimes referred to as Madeline) resided in Pittsburgh, Pennsylvania. Nick and Madeline were married during the years in issue, but were divorced in 1981.

During 1974, 1975, and 1976, Nick derived income from the operation of massage parlors and related activities. During these years, petitioners reported on their joint income tax returns Nick's wages as a fireman, interest, and management fees, but failed to report Nick's income derived from the operation of massage parlors and related activities.

In the criminal case of *United States v. Nicholas A. DeLucia, Jr.*, Criminal No. 80-24 (W.D. Pa. 1980), the grand jury charged in Count Two of the indictment that Nick violated section 7201 for 1975 by attempting to evade most of his income tax liability. The grand jury charged that his income tax liability was $35,675.46, and that his taxable income was $84,233.56. For 1975, petitioners had reported taxable income of $3,912.76 and a tax liability of $485.17. On February 10, 1981, Nick entered a plea of guilty to Count Two of the indictment. A judgment of conviction was pronounced and a sentence of 5 years incarceration was imposed on Nick on that same day.

On April 29, 1983, respondent issued to petitioners a notice of deficiency for 1974, 1975, and 1976 determining the above-described deficiencies and additions to tax. Petitioners filed their petition on July 28, 1983, disputing the asserted deficiencies and additions to tax on grounds that (1) the deficiencies were based on additional income as shown in a sealed grand jury indictment, (2) there is no evidence to support the deficiencies, and (3) the Commissioner has not taken into account any nontaxable sources of income in computing the deficiencies. Respondent filed his answer on September 26, 1983, further alleging the facts upon which his determination of the deficiencies and additions to tax is based.

On January 4, 1985, respondent notified petitioners that a conference had been arranged for January 9, 1985, pursuant to which respondent and petitioners were to consult and communicate informally in accordance with the Tax Court's Rules of Practice and Procedure before their trial, which was scheduled for a trial session starting on April 15, 1985. In the "*Branerton* letter",[3] respondent stated that "if the above conference date or time is unsuitable, please contact me in order to arrange for another date or time." Petitioners failed to attend this conference, failed to contact respondent as to this conference, and failed to furnish respondent with the requested information and documentation.

On January 10, 1985, respondent served petitioners with (1) Respondent's First Request for Admissions, (2) Respondent's First Set of Interrogatories, and (3) Respondent's First Request for Production of Documents. Petitioners failed to respond to respondent's request for admissions. On February 27, 1985, respondent filed with this Court a Motion to Compel Production of Documents and Responses to Respondent's Interrogatories. Petitioners failed to file an objection thereto, and on March 26, 1985, this Court granted respondent's motion and ordered petitioners to produce documents and answer interrogatories by April 5, 1985. This Court also ordered that, if petitioners failed to comply with the foregoing order, then they were to show cause at the April 15, 1985, Pittsburgh trial session why the Court should not impose sanctions against them pursuant to Rule 104, which may include dismissal of this case and entry of a decision against them.

On April 3, 1985, respondent filed respondent's motion for summary judgment, a memorandum brief of respondent in support of respondent's motion for summary judgment, and an affidavit.

At a hearing held on April 17, 1985, with respect to respondent's motion for summary judgment, this Court ordered, in pertinent part, as follows:

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[3] See *Branerton Corp. v. Commissioner*, 61 T.C. 691 (1974).

ORDERED that respondent's motion for summary judgment, filed April 3, 1985, is granted insofar as it relates to petitioner Nick Delucia. A decision shall be entered in due course. It is further

ORDERED that petitioner's oral motion to relieve Madeline A. Delucia of the effects of Admission No. 11(4) is granted and petitioner Madeline A. Delucia, pursuant to Rule 90(e) * * * is hereby relieved of the effects of deemed Admission No. 11 of respondent's First Request for Admissions, served upon petitioners January 10, 1985. It is further

ORDERED that respondent's motion for summary judgment, filed April 3, 1985, is granted in part and denied in part insofar as it relates to petitioner Madeline A. Delucia as follows: Respondent's said motion is granted in that it is established that (apart from the possible effect of Section 6013(e) * * *) there are deficiencies in income tax for the years and in the amounts set forth in the statutory notice of deficiency, that some part of each of these deficiencies is due to the fraud of petitioner Nick Delucia, that the statute of limitations is not a bar to the assessment of any of these deficiencies, and that petitioners failed to report income on their tax returns for the years in issue in the amounts and from the sources referred to in respondent's request for admissions. Respondent's said motion is denied but only insofar as it seeks to preclude petitioner Madeline A. Delucia from further contending that she is entitled to relief under Section 6013(e) from liability for any part or all of the deficiency for each of the years in issue. * * *

The Court's order to show cause was modified and, in compliance therewith, on May 31, 1985, Madeline served answers to respondent's interrogatories on respondent; she stated therein that she did not possess any documents of the sort that were required to be produced.

On August 28, 1986, respondent served on petitioners a notice of deposition under Rule 75, stating respondent's intention to depose Nick on September 11, 1986.[5] Petitioners objected to the deposition on September 10, 1986, on grounds that (1) Nick is a party to this proceeding and (2)

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[4] Admission No. 11 of respondent's first request for admissions states as follows:

11. Petitioner Madeline A. DeLucia, in signing the joint returns for the years 1974, 1975, and 1976, knew or had reason to know of: (a) the income-producing activities of petitioner Nick DeLucia, Jr. in the operation of massage parlors and related activities; (b) that income derived from these sources was not reported on their respective joint returns for the years 1974, 1975, and 1976; (c) that the amounts derived from the operation of massage parlors and related activities were not reported to their return preparer for the years 1974, 1975, and 1976; and (d) the failure to report these amounts resulted in a substantial understatement of the joint tax liability of Nick and Madeline DeLucia for the years 1974, 1975, and 1976.

[5] Rule 75(d) provides that objections to a notice of deposition are to be served within 15 days after service of the notice of deposition. In view of (1) our disposition of respondent's motion to compel deposition, and (2) the fact that no objection has been raised in this proceeding relating to the appropriateness of scheduling a deposition only 14 days after service of the notice of deposition, we leave for another day any ruling as to the possible effects of this shortened time period.

the Tax Court rules do not provide for the deposition of a party.[6] As a result of this objection, respondent, on September 12, 1986, filed a motion to compel deposition with this Court. This motion sets forth the following reasons as to why respondent believes his motion should be granted:

> 11. All informal consultations with counsel for Madeline A. DeLucia proved to be unfruitful, inasmuch as counsel for Madeline A. DeLucia reiterated that Madeline DeLucia had no documents, had no records, that all records were in the custody of the United States Attorney who had conducted the Grand Jury, and that Madeline A. DeLucia was an innocent spouse.
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> 12. Thus, on August 28, 1986, respondent, fully cognizant of the fact that a deposition under Rule 75 is an extraordinary discovery device, but believing that Nicholas A. DeLucia, Jr. is the only source of information available which could shed light on the matter concerning the innocent spouse status of Madeline A. DeLucia in the above-captioned case, issued his Subpoena and Notice of Deposition under Rule 75, directing Nicholas DeLucia, Jr. to appear * * * and there to testify on behalf of the Commissioner of Internal Revenue in the above-entitled case. * * *
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> * * * * * * *
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> 16. It is submitted that Nick DeLucia, Jr. is no longer a party to this case, inasmuch as all issues concerning him have been concluded.
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> 17. Nick DeLucia, Jr. remains one of the primary sources and probably the best source of information concerning the status of Madeline A. DeLucia in the years 1974 through 1976, concerning her knowledge, participation, awareness and benefits attending the non-reporting of items of income on their respective joint returns for the years 1974 through 1976.

This matter is before the Court on respondent's motion to compel deposition pursuant to Rule 75, filed on September 12, 1986. Petitioners oppose this motion.

The only substantive issue remaining in the underlying case is the question whether Madeline is entitled to relief from liability for tax under section 6013(e), the "innocent spouse" provision. As previously noted, this Court granted partial summary judgment in favor of respondent with respect to Nick's liability for the deficiencies and the additions to tax under section 6653(b).

Rule 75, effective for pending or future cases as of January 4, 1983, permits compulsory discovery depositions of nonparty witnesses to be taken without the consent of the parties. However, the circumstances under which nonconsensual depositions will be ordered are very limited and are carefully set forth in the Rule itself. See 79 T.C. 1135, 1140. Rule 75 provides in relevant part as follows:

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[6] We assume petitioners are referring to Rule 75, since Rule 74 clearly authorizes the taking of a party's deposition if that party so consents.

> RULE 75. DEPOSITIONS FOR DISCOVERY PURPOSES—WITHOUT CONSENT OF PARTIES IN CERTAIN CASES
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> (a) When Depositions May Be Taken: After a notice of trial has been issued or after a case has been assigned to a Judge or Special Trial Judge of the Court, and within the time for completion of discovery under Rule 70(a)(2), any party may, without leave of Court, take a deposition for discovery purposes of a non-party witness in the circumstances described in paragraph (b) of this Rule.
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> * * * * * * *
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> (b) Availability: The taking of a deposition of a non-party witness under this Rule is an extraordinary method of discovery and may be used only where a non-party witness can give testimony or possesses documents or things which are discoverable within the meaning of Rule 70(b) and where such testimony, documents, or things practicably cannot be obtained through informal consultation or communication (Rule 70(a)(1)) or by a deposition taken with consent of the parties (Rule 74). If such requirements are satisfied, a deposition may be taken under this Rule, for example, where a party is a member of a partnership and an issue in the case involves an adjustment with respect to such partnership, or a party is a shareholder of an electing small business corporation (as defined in Code Section 1371(b)) and an issue in the case involves an adjustment with respect to such corporation.
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> (c) Notice: A party desiring to take a deposition under this Rule shall give notice in writing to every other party to the case and to the non-party witness to be deposed. The notice shall state that the deposition is to be taken under Rule 75 and shall set forth the name of the party seeking the deposition, the name and address of the person to be deposed, the time and place proposed for the deposition, and the officer before whom the deposition is to be taken. * * *

In order to avail himself of Rule 75, respondent must pass the threshold requirement that the person he wishes to depose is a "non-party witness" within the meaning of Rule 75(a).

Respondent contends that Nick "is no longer a party to this case, inasmuch as all issues concerning him have been concluded" by virtue of this Court's order granting partial summary judgment. The logical inference from respondent's contention is that if Nick is no longer a party to this proceeding, he may be a nonparty witness for purposes of Rule 75.

Petitioners object to the taking of the deposition under Rule 75 on grounds that Nick remains a party to this proceeding, notwithstanding that all issues as apply to him have been resolved. Thus, argue petitioners, because Nick continues to be a party and Rule 75 does not apply to party deponents, respondent's motion must be denied.

We agree with petitioners.

When we granted to respondent summary judgment with respect to Nick, thereby concluding that Nick was liable for the deficiencies and additions to tax determined by respondent, we stated that: "A decision shall be entered in due course."

There is no dispute that Nick and Madeline filed a joint petition to commence the instant case and that both of them thereby became parties in the instant case. See Rule 61(a); see also Rule 60(a)(1).

Nothing has happened to change Nick's status as a party. No severance order has been issued under Rule 61(b) or Rule 62. No decision has been entered as to Nick.[7] Nick is not permitted to appeal the summary judgment order because it is interlocutory and therefore not final. *Shapiro v. Commissioner*, 632 F.2d 170 (2d Cir. 1980).[8]

Accordingly, Nick remains a party in the instant case.

Rule 75 applies only to nonparty witnesses. Since Nick still is a party in the instant case, the literal language of Rule 75 precludes the application of that Rule to Nick.

In *Nordstrom v. Commissioner*, 50 T.C. 30 (1968), a petition was filed by husband and wife petitioners. Respondent moved to dismiss the case with regard to taxpayer-husband, for lack of prosecution, and to determine the deficiencies and additions to tax due from taxpayer-husband. Respondent argued that his motion should be granted because (1) taxpayer-husband had died, (2) his will would not be probated, (3) no special representative would be appointed to act on his estate's behalf, and (4) a settlement stipulation had been executed by taxpayer-wife and respondent which determined the wife's liability for deficiencies and additions to tax in the same amounts as those asserted against taxpayer-husband. We concluded in *Nordstrom* as follows (50 T.C. at 32):

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[7] Sec. 7459(c) provides, in relevant part, as follows:

SEC. 7459. REPORTS AND DECISIONS.

(c) DATE OF DECISION.—A decision of the Tax Court (except a decision dismissing a proceeding for lack of jurisdiction) shall be held to be rendered upon the date that an order specifying the amount of the deficiency is entered in the records of the Tax Court * * *

The references to sec. 7459(c), and the section references that appear hereinafter, are to sections of the Internal Revenue Code of 1954 as in effect on the date this opinion is filed. See note 2 *supra*.

[8] Sec. 1558 of H.R. 3838, the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2757, overruling *Shapiro v. Commissioner*, 632 F.2d 170 (2d Cir. 1980), applies to orders entered after the date of enactment of this act. Even then, the new statutory provision would give the Courts of Appeals only a limited discretionary authority to entertain interlocutory appeals.

> The foregoing [precedent] makes it clear that the Court's jurisdiction over a case continues unimpaired by the death of a petitioner and even though there is no personal representative appointed to act in the place and stead of the decedent. *And if our jurisdiction continues, then there must be a procedural means to bring the case to a close.*
>
> Such a means, it seems to us, is the device of having the respondent move to dismiss the case for lack of prosecution. Under section 7459(d) * * * , if the Court dismisses a case, its decision—
>
> dismissing the proceeding shall be considered as its decision that the deficiency is the amount determined by the Secretary or his delegate. An order specifying such amount shall be entered in the records of the Tax Court * * * .
>
> The impact of that statutory provision is, of course, that a dismissal for lack of prosecution will bring the case to a close in this Court.
>
> [Emphasis added.]

Accord *Estate of Ming v. Commissioner*, 62 T.C. 519, 521 (1974) ("'a taxpayer may not unilaterally oust the Tax Court from jurisdiction which, once invoked, remains unimpaired until it decides the controversy.'")

As in *Nordstrom*, this Court will not lose jurisdiction over Nick merely because all issues surrounding Nick's tax liability were resolved when this Court granted, in part, respondent's motion for summary judgment. Rather, this case involves joint petitioners, and one issue concerning Madeline's tax liability has yet to be resolved. Thus, no decision is to be entered pursuant to section 7459(c) as respects Nick's liability until a determination is made regarding Madeline's liability, as well.

There are additional reasons why Nick is to be considered a party to this proceeding. As was already stated above, this Court retains jurisdiction over a party through the time that a decision is entered with regard to that party pursuant to section 7459(c). More importantly, the entry of decision is the event that triggers certain rights of the party under the Internal Revenue Code and the Rules of this Court. For example, upon the entry of decision, a party will be able to move to vacate or revise this Court's decision (Rule 162). The entry of decision triggers the 90-day period in which the party may appeal the Tax Court's decision (sec. 7483; Rule 190(a)). The Internal Revenue Service may not make any assessment or levy as to the taxes owed by a party until this Court's decision has become final pursuant to section 7481 (secs. 6213(a), 6331(a)). Nor can any lien arise until the Service is permitted to make the assessment of the taxes owed by the party as determined by this Court in its decision (sec. 6322). Thus, even after this Court enters its decision, a party maintains his or her status as a party for other Internal Revenue Code provisions.

Nothing in the policy giving rise to Rule 75 would be served by treating Nick as "a non-party witness" for purposes of Rule 75. Rules 71, 72, and 74 apply to parties. Rule 75 is an extraordinary method of discovery. The Court's purpose in adopting Rule 75 is described as follows in the Rules Committee's notes (79 T.C. at 1141-1142):

> Under the Rule, a discovery deposition may be taken only of a witness who is not a party to the case; the deposition of a party may be taken only upon consent of all parties under Rule 74. The new Rule 75 provides an extraordinary method of discovery which may be used only where the information sought cannot be obtained by informal consultation or by other discovery methods. For example, if the other requirements of the Rule are satisfied, a deposition might be taken under the Rule in a case involving the tax liability of a limited partner who does not have access to the books and records of the partnership, or where a bank or other person possesses records which are relevant to the tax liability of a party and are otherwise unavailable.

It does not appear that any purpose would be served by deposing Nick except to get Nick's testimony before the trial. In the context of the instant case, this is not the sort of purpose for which Rule 75 was adopted. As the above-quoted Rules Committee note indicates, "the deposition of a party may be taken only upon consent of all parties under Rule 74." If we were to ignore the literal language of Rule 75 in order to permit respondent to depose Nick, we would merely be assisting respondent in circumventing both the literal language and the carefully limited objectives of our discovery rules. See *Estate of Van Loben Sels v. Commissioner*, 82 T.C. 64, 68-69 (1984).[9]

An appropriate order will be issued denying respondent's motion to compel deposition.

OTTO A. ANGERHOFER, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 22182-83, 17013-84,
17014-84, 26793-84,
40702-84, 40703-84,
5812-85.

Filed October 21, 1986.

Petitioners were citizens and domiciliaries of West Germany in the taxable years at issue. During those years, I.B.M. in New York employed petitioner-husbands and paid their wages. *Held*: Under the applicable laws of West Germany, petitioner-husbands' U.S. earnings were not community property, and petitioner-wives did not have present vested interests in the earnings. Accordingly, under sec. 1, I.R.C. 1954, petitioner-husbands must include in taxable income the full amount of their earnings while employed in the United States.

O. Thomas Johnson, Jr., and *John B. Jones, Jr.*, for the petitioners.

Frank M. Lavadera, for the respondent.

PARR, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Petitioner	*Fiscal year*	*Calendar year*	*Deficiency*
Otto A. Angerhofer		1980	$6,632.09
Monika Angerhofer		1980	1,166.00
Karl-Eduard Biedermann		1981	4,904.00
Werner A. Ewert	Aug. 31, 1979		57,524.58
	Aug. 31, 1980		33,246.00
Hedda Ewert	Aug. 31, 1979		14,401.87
	Aug. 31, 1980		9,458.00

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[9] See also *Howe v. Commissioner*, T.C. Memo. 1985-213.

[1] The following cases were consolidated for trial, briefing, and opinion: Otto A. Angerhofer, docket No. 22182-83; Monika Angerhofer, docket No. 26793-84; Karl-Eduard Biedermann, docket No. 5812-85; Werner A. Ewert, docket No. 17014-84; Hedda Ewert, docket No. 17013-84; Helmut Wenzel, docket No. 40702-84; Annemarie Wenzel, docket No. 40703-84.

Petitioner	*Fiscal year*	*Calendar year*	*Deficiency*
Helmut Wenzel		1979	$42,092.00
		1980	34,667.00
	May 31, 1979		22,640.00
	May 31, 1980		29,988.00
	May 31, 1981		18,321.00
Annemarie Wenzel		1979	11,857.00
		1980	5,760.00
	May 31, 1979		3,714.00
	May 31, 1980		5,390.00

The issue for decision[2] is whether petitioners Otto A. Angerhofer, Karl-Eduard Biedermann, Werner A. Ewert and Helmut Wenzel, citizens and domiciliaries of the Federal Republic of Germany (Germany) during the years at issue, are properly taxable on all or only one-half of the wages earned while temporarily in the United States. Those petitioners (hereinafter sometimes referred to as petitioner-husbands) argue that only one-half of such wages are includable in their taxable income on the ground that under the law of Germany, their wives (petitioners Monika Angerhofer, Hedda Ewert, and Annemarie Wenzel, sometimes referred to as petitioner-wives[3]) had a present vested interest in one-half of their earnings.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and related exhibits are incorporated herein by this reference.

Petitioners Otto A. and Monika Angerhofer resided in Germany at the time the petitions in docket Nos. 22182-83 and 26793-84 were filed. The Angerhofers are now, and at all times pertinent to these cases have been, citizens and domiciliaries of Germany.

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[2] At trial, the Court granted the parties' joint motion to sever all secondary issues from the trial of this issue. The intent of the parties is that those secondary issues will be resolved without trial and will be the subject of a supplemental stipulation to be filed by the parties with the Court.

[3] Karl-Eduard Biedermann's wife, Karla, did not receive a notice of deficiency from respondent, and thus is not a petitioner in this case. For convenience, however, the term petitioner-wife as used herein should be deemed to refer to Mrs. Biedermann as well as the other petitioner-wives.

The Angerhofers were married in Germany on August 23, 1974, and have never entered into any marital property contract.

From October 8, 1979, until July, 1980, Mr. Angerhofer was employed in New York by International Business Machines Corporation (IBM), a New York corporation, as a mechanical engineer. While employed by IBM in the United States, Mr. Angerhofer was on assignment from IBM Deutschland GmbH (IBM Deutschland). During this period, Mr. Angerhofer held an L-1 (intra-company transferee) visa, and Mrs. Angerhofer held an L-2 visa.

Since returning to Germany in July 1980, Mr. Angerhofer has been continuously employed by IBM Deutschland.

For the calendar year 1980, the Angerhofers, cash basis taxpayers, filed separate nonresident alien income tax returns with the Internal Revenue Service Center in Philadelphia, Pennsylvania. On his return for 1980, Mr. Angerhofer reported only one-half of his compensation from IBM. His return stated that he and his wife were domiciled in Germany, a community property country, and that such income was community income. The income tax return filed by Mrs. Angerhofer for 1980 reported the other one-half of Mr. Angerhofer's 1980 compensation.

Petitioner Karl-Eduard Biedermann resided in Germany at the time the petition in docket No. 5812-85 was filed. Mr. Biedermann and his wife, Karla Biedermann, are now, and at all times pertinent to this case have been, citizens and domiciliaries of Germany.

The Biedermanns were married in Germany on March 20, 1954, and have never entered into any marital property contract.[4]

From November 1, 1980, until June 9, 1981, Mr. Biedermann was employed in New York by IBM as a data-processing consultant. While employed by IBM in the United States, Mr. Biedermann was on assignment from IBM Deutschland. During this period, Mr. Biedermann held an L-1 visa and Mrs. Biedermann held an L-2 visa.

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[4] Petitioner Karl-Eduard Biedermann originally argued that he and his wife had elected an optional marital regime known as gütergemeinschaft, which respondent concedes is a community property regime. On brief, however, petitioner conceded that the marital contract had never been properly notarized or filed, as required under German law.

Since returning to Germany in June 1981, Mr. Biedermann has been continuously employed by IBM Deutschland.

For the calendar year 1981, the Biedermanns, cash basis taxpayers, filed separate nonresident alien returns with the Internal Revenue Service Center in Philadelphia, Pennsylvania. On his income tax return, Mr. Biedermann reported only one-half of his compensation from IBM. His return stated that he and his wife were domiciled in Germany, a community property country, and that such income was community income. Mrs. Biedermann's 1981 income tax return reported the other one-half of Mr. Biedermann's 1981 compensation.

Petitioners Werner A. Ewert and Hedda Ewert resided in Germany at the time the petitions in docket Nos. 17014-84 and 17013-84 were filed. The Ewerts are now, and at all times pertinent to these cases have been, citizens and domiciliaries of Germany.

The Ewerts were married in Germany on April 28, 1956, and have never entered into any marital property contract.[5]

From March 1977, until February 1980, Mr. Ewert was employed in New York by IBM as a manager of marketing, support, and services. While employed by IBM in the United States, Mr. Ewert was on assignment from IBM Deutschland. During this period, Mr. Ewert held an L-1 visa and Mrs. Ewert held an L-2 visa.

Since returning to Germany in February 1980, Mr. Ewert has been continuously employed by IBM Deutschland.

For the fiscal years ending August 31, 1979 and August 31, 1980, the Ewerts, who are cash basis taxpayers, filed separate nonresident alien income tax returns with the Internal Revenue Service Center in Philadelphia, Pennsylvania. On his returns, Mr. Ewert reported only one-half of the compensation that he earned from IBM during 1979 and 1980. The returns stated that he and his wife were domiciled in Germany, a community property country, and that such income was community property income. Mrs.

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[5] The Ewerts also originally argued that they had privately contracted the marital regime gümutergemeinschaft, but conceded on brief that their agreement was not binding under German law.

Ewert's returns for those fiscal years reported the other one-half of Mr. Ewert's 1979 and 1980 compensation.

Petitioners Helmut Wenzel and Annemarie Wenzel resided in Germany at the time the petitions in docket Nos. 40702-84 and 40703-84 were filed. The Wenzels are now, and at all times pertinent to these cases have been, citizens and domiciliaries of Germany.

The Wenzels were married in Germany on May 9, 1963, and have never entered into any marital property contract.

From December 1, 1978, until December 22, 1980, Mr. Wenzel was employed in New York by IBM as a personnel manager. While employed by IBM in the United States, Mr. Wenzel was on assignment from IBM Deutschland. During this period, Mr. Wenzel held an L-1 visa and Mrs. Wenzel held an L-2 visa.

Since returning to Germany in December 1980, Mr. Wenzel has been continuously employed by IBM Deutschland.

For the fiscal years ending May 31, 1979, May 31 1980, and May 31, 1981, the Wenzels, who are cash basis taxpayers, filed separate nonresident alien income tax returns with the Internal Revenue Service Center in Philadelphia, Pennsylvania. On his returns, Mr. Wenzel reported only one-half of the compensation he earned from IBM during 1979 through 1981. The returns stated that he and his wife were domiciled in Germany, a community property country, and that such income was community property income. Mrs. Wenzel's returns for those fiscal years[6] reported the other one-half of Mr. Wenzel's compensation.

In his notices of deficiency to petitioner-husbands, respondent disallowed the claimed community property benefits, stating:

> Community property benefits have been disallowed because it has not been established that your spouse's income is subject to the law of any jurisdiction that grants one spouse a present vested interest in 50 percent of the other's income from personal services.

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[6] Mrs. Wenzel received a notice of deficiency with regard to her fiscal year 1979 and 1980 returns only.

OPINION

Section 1[7] imposes a tax "on the taxable income of every married individual (as defined in section 143) who does not make a single return jointly with his spouse under section 6013." Petitioners, nonresident aliens, are ineligible to file joint returns under section 6013(a)(1).

Notwithstanding that prohibition, petitioner-husbands may effectively split their income with their nonwage-earner wives if such income is "community income" in which each spouse has a present vested interest. *Poe v. Seaborn*, 282 U.S. 101 (1930); *Goodell v. Koch*, 282 U.S. 118 (1930); *Hopkins v. Bacon*, 282 U.S. 122 (1930); *Bender v. Pfaff*, 282 U.S. 127 (1930).

The interest of one spouse in the property brought to the marriage or acquired during marriage by the other spouse, absent agreement between them, is generally determined by the laws of their domicile. *Westerdahl v. Commissioner*, 82 T.C. 83, 86 (1984); *Rosenkranz v. Commissioner*, 65 T.C. 993, 996 (1976); *Zaffaroni v. Commissioner*, 65 T.C. 982, 986-987 (1976).

The parties agree that petitioners were domiciled in Germany during the years in issue. Therefore, the question of whether the salary earned by each petitioner-husband is his separate property or the community property of both him and his wife is to be determined under the laws of Germany. We must determine whether German law gives each petitioner-wife a present vested interest in her husband's earned income.[8] Under Rule 146, Tax Court Rules of Practice and Procedure, the determination of foreign law is treated as a ruling on a question of law.

The parties have stipulated copies of pertinent provisions of the Bürgerliches Gesetzbuch (hereinafter BGB), the German Civil Code, together with English translations thereof. In addition, the parties presented the testimony of experts in German law. We have considered the evidence presented and have analyzed the applicable German law in light of the standards we set forth in *Westerdahl v. Commissioner*, *supra*. We conclude that the German matrimonial regime which governs petitioners' marital relationships is not one of community property, and therefore each spouse does not have a present vested interest in one-half of the other spouse's earnings. Petitioner-husbands must therefore include in taxable income the full amount of their earnings while employed in the United States.

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[7] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended.

[8] We note that for tax years beginning after 1984, sec. 879(a) has eliminated the tax benefits sought in these cases, by providing that in the case of a married couple where one or both of the spouses are nonresident aliens and only one spouse has income effectively connected with a U.S. trade or business, such income is treated solely as the income of the spouse who earned it, regardless of foreign community property laws.

German law provides for three alternative marital regimes, gümutertrennung, gümutergemeinschaft, and zugewinngemeinschaft. The three regimes in their present form were introduced by the Law on the Equality of the Sexes of 1958. The first two marital regimes are elective; in the absence of a proper election a couple's marital relationship is governed by zugewinngemeinschaft, also known as the statutory marital regime. Zugewinngemeinschaft is generally translated into English as "community of accrued gains."

As noted previously, none of the petitioners in this case have made a proper election for a regime other than the statutory regime. We must therefore analyze the laws governing the zugewinngemeinschaft regime to determine whether a spouse has a present vested interest in one-half of the income earned by the other spouse. It is helpful to our analysis, however, to first briefly describe the two optional marital regimes for purposes of comparison.

BGB section 1414 provides for the establishment of the gümutertrennung ("separation of property") regime as follows:

> If the spouses exclude or eliminate the statutory matrimonial regime, separation of property occurs, except if their marriage contract otherwise provides. The same applies if the equalization of accrued gains is excluded or the equalization of support or the community of property is eliminated.

Gümutertrennung is thus an elective regime in which each spouse acquires and maintains his or her own separate property, with no ownership interest in property acquired by the other spouse. A spouse may freely manage his or her income or property without restriction.

In contrast, gümutergemeinschaft ("community of property") provides for a joint pot of marital property, known as the gesamtgut, which both spouses own equally. The management of the gesamtgut is therefore subject to restrictions intended to assure the protection of each spouse's share of the marital property.

BGB sections 1415 through 1518 provide for the gümutergemeinschaft matrimonial regime. BGB section 1416(1) states that:

> The property of the husband and the property of the wife become through community of property the joint property of both spouses (common property). Property which comes into the ownership of husband or wife during the period of community of property also belongs to the common property.

The spouses must agree by notarized contract to have community of property. BGB sec. 1410. Although property acquired during the marriage is common property, property owned by either spouse prior to the marriage can remain separate property, as well as the appreciation relating to that property. BGB sec. 1418, 1477, 1478. The common property is managed by both spouses jointly, in the absence of an agreement providing otherwise. BGB sec. 1421. Upon termination of the marriage, the goods comprising the gesamtgut are divided equally between the spouses. BGB sec. 1471 et seq. If the marriage terminates at death, the share of the deceased spouse in the gesamtgut belongs to his or her estate and thus passes to his or her beneficiaries or legal heirs. BGB sec. 1482.

Where a marriage is governed by the gümutergemeinschaft regime, and the property is managed jointly, neither spouse can individually obligate the common property, except for household obligations. BGB sec. 1450 et seq. If one spouse has been designated the manager, he or she can obligate the property, but has a duty of proper management. BGB sec. 1435. If the managing spouse improperly obliges or risks the gesamtgut, the other spouse can sue to restore the amount to the gesamtgut, or bring an action for premature dissolution of the matrimonial regime. The latter remedy results in the premature division of the joint property, and gümutertrennung applies thereafter. BGB sec. 1447, 1449.

In the absence of a valid election, a German couple is subject to the zugewinngemeinschaft regime, which contains some elements of the gümutergemeinschaft, but with notable exceptions. It is this regime that is at issue in these cases.

Sections 1363 through 1383 of the BGB describe the zugewinngemeinschaft, the statutory marital regime. BGB section 1363, which describes the regime generally, is particularly significant to our determination of whether a spouse has a present vested interest in the other spouse's property:

> **Section 1363. [Community of Accrued Gains].**
>
> (1) The matrimonial regime in which the spouses live is one of community of accrued gains unless they agreed otherwise by marriage contract.
>
> (2) The property of the husband and the property of the wife will not become joint property of the spouses; this also applies to property acquired by a spouse after entering the marriage. Gains made by the spouses during the marriage shall, however, be equalized if the community of accrued gains comes to an end.

This regime therefore provides for the ownership and maintenance of separate property by husband and wife, with an "equalization of gains" upon termination of the marriage. Equalization is effected in different ways, depending on whether the marriage terminates by death or inter vivos.

Where the marriage (or, more accurately, the marital regime) ends inter vivos, each spouse's zugewinn ("increment of property owned") is calculated and the two figures are compared. The difference is divided in half and this amount becomes a monetary claim of the spouse with the smaller zugewinn. The zugewinn is computed by comparing the property a spouse owned at the beginning of the marriage with the property owned at the end of the marriage. Gifts or inheritances received by a spouse during the marriage are included in his or her beginning property. Where a spouse's beginning property has appreciated during the marriage, the appreciation is included in accrued gains; however, there is an adjustment to account for inflationary gains. The procedure for partitioning the "community of accrued gains" is thus one of valuation, computation, and payment of a monetary amount to the spouse with the smaller zugewinn. See generally BGB secs. 1373 through 1383.

The zugewinngemeinschaft can come to an end inter vivos by several means: divorce, voidance of the marriage, separation for more than 3 years, or premature equalization.

Under zugewinngemeinschaft, each spouse manages his or her own property independently. BGB sec. 1364. Certain restrictions apply to prevent detriment to the other spouse, however. The only two true restrictions are on disposing of one's entire estate or disposing of household goods without the other spouse's consent. BGB secs. 1365, 1369. In addition, where a spouse wastes assets, makes improper gifts, or transfers assets to the detriment of the other spouse, those amounts are treated as still part of his or her final estate, and are included in the amount to be equalized. BGB sec. 1375. Examples in this category are a spouse's gambling or gifts to a mistress.

Where a spouse attempts to dispose of his or her entire estate, or makes gifts or otherwise wastes assets so that the other spouse's equalization claim may be jeopardized, a claim for premature equalization may be brought and the marriage will continue under gümutertrennung. BGB secs. 1386, 1388. However, if there will be sufficient property in the estate to satisfy the equalization claim, there is no jeopardy, and therefore the remedy of premature equalization is unavailable.

The equalization claim always takes the form of a monetary claim by the spouse with the smaller zugewinn. It is not a division of property. In addition, the spouse with the smaller zugewinn can only collect up to the amount in the other spouse's estate. BGB sec. 1378(2). (However, where the spouse with the larger zugewinn cannot fulfill his or her equalization obligation due to having made unjust gifts to a third party, the other spouse can sue the third party for restitution of the gifts. BGB sec. 1390).

Where the marital regime terminates by the death of a spouse, the equalization of accrued gains as described above need not take place. Instead, if there is no will, the surviving spouse is entitled to a "constructive equalization" which is an extra one-quarter of the deceased spouse's estate over and above the surviving spouse's statutory share. The surviving spouses's statutory share is either 100 percent, 50 percent, or 25 percent of the estate, depending on the existence of other heirs. A surviving spouse is entitled to constructive equalization upon the intestate death of his or her spouse regardless of who had the larger or smaller zugewinn. BGB sec. 1371(1).

If there is a will, but it leaves the surviving spouse less than half of the statutory share (grossed-up by the extra one-quarter), he or she can demand from the heirs the difference between the bequest and that amount. If the surviving spouse is left nothing under the will, he or she can demand actual equalization of accrued gains plus the statutory share, which in this case is not grossed-up by the additional one-quarter. Lastly, if the will leaves the surviving spouse more than half the grossed-up statutory share, but less than the actual equalization claim plus statutory share, the surviving spouse may disclaim the inheritance and elect equalization plus the statutory share. See BGB secs. 1371, 2303, 2305.

If it is the spouse with the smaller zugewinn who has died, his or her estate is not entitled to the equalization claim which might have been claimed had the marriage ended inter vivos. Therefore, the equalization claim is only transmittable to a spouse's descendants if he or she is alive at the time of equalization.

During the continuation of the marital regime, the spouses treat their property as separate property. A spouse cannot obligate the other spouse's property as collateral. A creditor of one spouse cannot attach the property of the other spouse to satisfy the debt (unless the debt was incurred in managing the household) or the tort liability of the first spouse. As stated above, a spouse may freely transfer his or her own separate property (except for household goods or the entire estate), although the value of certain transferred assets may later be brought back into the computation of accrued gains.

The equalization claim arises only upon termination of the marital regime. BGB sec. 1378(3). It cannot be used as collateral, bequeathed, or otherwise disposed of prior to the end of the marriage.

Upon termination of the marital relationship, there is no tax to the spouse who receives the equalization amount, under either the German gift tax, income tax, or inheritance tax provisions.

In determining whether the zugewinngemeinschaft regime, described above, gives petitioner-wives a present vested interest in their husbands' earnings, we rely to a considerable extent on our opinion in *Westerdahl v. Commissioner*, 82 T.C. 83 (1984). In *Westerdahl*, we determined that under the laws of Sweden, the taxpayers' U.S. earnings were community property. We began our analysis with a general discussion of the American community property States:

> The cardinal principles upon which the American States' community property legal systems are built involve (1) maintenance of the separate identity of each spouse, and (2) mutuality of spousal interests in marital property. These two principles obviously presume the existence of a conjugal partnership. [*Westerdahl v. Commissioner, supra* at 88. Fn. ref. omitted.]

Like the taxpayers in *Westerdahl*, petitioners herein argue that Germany's marital laws should be compared with the laws of the eight recognized American community property States[9] and the principles set forth in *Poe v. Seaborn*, 282 U.S. 101 (1930), and its companion cases (cited *supra*). We agree. In support of this argument, petitioners on brief have devoted much attention to analyzing the restrictions on management of property and the division of property at the end of a marriage under both zugewinngemeinschaft and the American community property States. We accept petitioners' analysis and agree that many of the attributes of a community property system are found in zugewinngemeinschaft. It is what is not found that is determinative in this instance, however.

The Supreme Court in *Poe v. Seaborn, supra*, found that Mrs. Seaborn had a present vested interest in her husband's income based on the laws of Washington State. As we stated in *Westerdahl*,

> In making this determination, the Court looked at the spouses' responsibilities, legal obligations, and limitations with respect to one another and

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[9] Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

> to the community property. It regarded several factors as particularly important, but it did not label these factors as requisites for finding a present vested interest. The several factors, when combined and viewed as two broad attributes, include: Protection of the interest of each spouse in the community property (1) by legally assuring its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse, and (2) by limiting the managing spouse's powers of management and control so that detriment to the nonmanaging spouse from fraud or mismanagement will be minimized.
>
> [*Westerdahl v. Commissioner, supra* at 91. Fn. ref. omitted.]

We also noted that in addition to the two broad attributes of *Poe v. Seaborn, supra*, other factors should be considered in determining whether a spouse has a present vested interest in community property. We stated that:

> In reviewing the statutes of the eight American community property States, we are aware of the presence or lack of presence of rules that—
>
> (1) Make the community property liable for the managing spouse's separate torts;
>
> (2) Prevent the nonmanaging spouse from obligating by contract the community property;
>
> (3) Require, except in extraordinary circumstances, equal division of the community property upon its partition at divorce;
>
> (4) Allow the managing spouse to discharge his separate debts from community; and
>
> (5) Require the managing spouse to make an accounting of all community property, including wages, when partitioned at the time of divorce.

No one factor is determinative of the issue at hand. *Westerdahl v. Commissioner, supra* at 94.

Petitioners go to great lengths on brief to compare the features of the zugewinngemeinschaft regime to the laws of the American community property States as well as Sweden. After comparing management of income, liability of property for torts, right to obligate the property by contract, payment of separate debts, and right to an accounting from the managing spouse, petitioners conclude that "while Germany sometimes differs from some of the approved states, it does so only on matters with respect to which the approved states differ among themselves." (Petitioner's brief at 17).

Without going into great detail, suffice it to say that in terms of restrictions on management, liability of the property for debts and torts of each spouse, as well as division of the property upon inter vivos termination of the marital regime, we find the German zugewinngemeinschaft regime to be similar in many respects to both Swedish law and the laws of the American community property States. We find, however, that one of the two factors for a present vested interest specifically required by the Supreme Court is clearly missing here: the testamentary disposition or automatic passage of a decedent-spouse's share of the community property (or, in this case, equalization claim) to his or her heirs.

Under zugewinngemeinschaft, a spouse is not assured the passage of the equalization claim to his or her issue. Under BGB 1378(3), the equalization claim is not transferable nor subject to inheritance prior to the termination of the matrimonial regime. The spouse with the smaller zugewinn thus must survive in order to receive the equalization. The spouse may therefore be easily deprived of his or her half of the accrued gains, a concept which goes against any notion of a "presently vested interest" in addition to failing one of the two broad requirements found so essential by the Supreme Court in *Poe v. Seaborn, supra.* We find that without the assurance of passage of the equalization claim to each spouse's heirs, it is impossible to hold that a present vested interest exists.[10]

By the spouses' inability to transfer or oblige their equalization claims it is also clear that those claims are merely expected future interests and not present vested interests. A mere "expectancy" in a spouse's income does not qualify for community property benefits under the tax laws. *Westerdahl v. Commissioner, supra* at 90. Again, this conclusion is supported by BGB sec. 1378, which provides that the claim for equalization does not arise until termination of the marriage.

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[10] Petitioners point out that the laws of both Nevada and New Mexico did not permit a wife to testamentarily dispose of her half of the couple's community property prior to changes in those States' laws in 1959 and 1975, respectively. Both jurisdictions had already been labeled "approved" community property States by the Internal Revenue Service in 1930, following the Supreme Court decision in *Poe v. Seaborn*, 282 U.S. 101 (1930), and its companion cases. Mim. 3853, X-1 C.B. 139 (1931). The fact that an administrative ruling was made with regard to those States which appears to have been less restrictive than the Supreme Court's test in *Seaborn*, and which thus conferred a tax benefit that may not have been warranted at the time, does not change our result in this case.

Moreover, it seems clear that the intent of the Germa statutory scheme was not to create a community propert regime under zugewinngemeinschaft. We do not disput petitioners' statement, made over and over again on brie that local labels do not determine Federal tax law consequences. See *Morgan v. Commissioner*, 309 U.S. 78, 8 (1940); *United States v. Davis*, 370 U.S. 65, 70 (1962 However, even petitioners concede that Federal courts mus look to local law to determine what rights in property ar held by the parties. *Warburton v. White*, 176 U.S. 484, 49 (1900). Therefore, while we do not find it to be determinative that Germany labels one regime "community property (gümutergemeinschaft) and another "community of accrue gains" (zugewinngemeinschaft), we cannot ignore the fac that the BGB expressly states that the spouses do not ow their property jointly (BGB sec. 1363). Nor can we ignore th fact that were petitioners earning this income in German and elected to file separate income tax returns, each coul report only his or her own wages and not his or he spouse's wages as income. Sec. 26, Einkommensteuergese (German Income Tax Act).

The legislative history of the BGB sections providing fo zugewinngemeinschaft is also consistent with this view, a are German legal commentators. The legislative histor states that neither spouse has a share in the other' property while the matrimonial regime exists, and eac spouse's property does not become community property.[1] Dr. Müller-Freinfels, in his learned treatise on Germa family law, also states that no real "community" exist and no spouse has an in rem right in the other spouse goods. Equalization is purely a monetary claim upon th dissolution of the marriage. W. Müller-Freinfels, "Famil Law and the Law of Succession in Germany," 16 Intl. Comp. L. Q. 409, 426-427 (1967). Lastly, Dr. Pete Schlechtriem, petitioners' expert and a family law professo in Germany, coauthored a commentary on this section the BGB when the law was adopted, in which he states tha

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[11] Special Committee of the German Federal Parliament, Drucksache 3409, Schriftlich Bericht des Ausschusses fümur Rechtswesen und Verfassung, Seite 5.

each spouse alone remains the owner of the property he or she acquired prior to or during the marriage. Iauernig, Schlechtriem & Sturner, Commentary on the BGB at 1245 (3d ed. 1984).

Finally, our holding today is consistent with our language in *Hall v. Commissioner*, T.C. Memo. 1978-360. In that case, a U.S. citizen residing in Germany with a French wife claimed that his income was community property. His argument, however, was that he was subject to the laws of either France or California, community property jurisdictions in which he had resided in the past, or of Andorra, where he resided following the years at issue. We held that he was domiciled in Germany during the years in issue, and that his income was not subject to the laws of a community property regime, stating:

> The German Civil Code, Sixth Title, section 1363 provides that a "community of accrued gains" is the prevailing matrimonial regime where the spouses do not provide otherwise by marriage contract. However, the term may be misleading, for the system is not one of community property. Rather, German law provides for a system of separate property during the existence of the marriage, with a claim for equalization of gains upon termination of the matrimonial regime. J. Leyser, " 'Equality of the Spouses' under the New German Law," 7 Am. J. Comp. L. 276, 279-280 (1968); W. Müller-Freinfels, "Family Law and the Law of Succession in Germany," 16 Intl. & Comp. L. Q. 409, 426 (1967); compare *Poe v. Seaborn*, 282 U.S. 101 (1930). [*Hall v. Commissioner, supra* (37 T.C.M. 1500, 1503, 47 P-H Memo T.C. par. 78,360, at 78-1491)].

While we are not bound by this language in *Hall*,[12] we agree with the conclusion reached in that opinion as to the interests of spouses in each other's property under zugewinngemeinschaft, and we reach the same conclusion in these cases. The zugewinngemeinschaft does not provide for a community of property and each spouse does not have a present vested interest in the other spouse's property.

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[12] Our discussion of this issue in *Hall v. Commissioner*, T.C. Memo. 1978-360, might be considered dicta. While the taxpayer in that case claimed on his returns that he was entitled to split income with his wife under the community property laws of Germany, he apparently abandoned that claim at trial; as stated above, he argued that he was subject to the laws of either California, France, or Andorra. Moreover, although we found that the taxpayer was domiciled in Germany, we held that Germany would look to the laws of the United States in that case (because the taxpayer was a U.S. citizen at time of marriage) to determine if the taxpayer's income was community property.

Therefore, petitioner-husbands are taxable on the full amount of their earnings while in the United States.

Decisions will be entered under Rule 155.

CARLTON L. BYRD, TRANSFEREE OF THE ASSETS OF
EASTERN SHORE NURSERY, INC., PETITIONER
v. COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

ROBERT H. WILLEY, JR., TRANSFEREE OF THE ASSETS
OF EASTERN SHORE NURSERY, INC., PETITIONER
v. COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

Docket Nos. 32626-84, 32699-84. Filed October 27, 1986.

Petitioners are transferees. As shareholders of transferor, they sold all of the stock of transferor, a subchapter S corporation, to a third party in March of 1980 and the transferor was liquidated. Transferor, a corporation engaged in the nursery business, had deducted in prior years the expenses of growing plants which remained in its inventory of plants at the time of liquidation. *Held*, the value of the inventory of plants which were transferred to the purchaser must be included in the income of the transferor, and hence the petitioners, in 1980 under the tax benefit rule.

Douglas E. Kahle, for the petitioners.
Richard F. Stein, for the respondent.

OPINION

DRENNEN, *Judge*: These cases have been consolidated for trial pursuant to Rule 141. [1] Respondent determined a deficiency in the Federal income tax of Eastern Shore Nursery of Virginia, Inc. (Eastern Shore or the corporation), for the taxable year 1980 of $113,480.62. Petitioners are liable for this deficiency as transferees of the assets of Eastern Shore. Respondent issued notices of transferee liability to each petitioner for the above deficiency on June 14, 1984. It is stipulated and found that petitioners are transferees at law and in equity of assets of Eastern Shore, within the meaning of section 6901, I.R.C. 1954, and are liable for any deficiency in income tax due from the transferor, Eastern Shore, for the taxable year ended March 29, 1980.

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years at issue.

The issue in this case is whether, pursuant to the tax benefit rule and section 111, Eastern Shore is required to include as income on its final return $244,880 of previously expensed plant inventory which was distributed to its shareholder, a partnership, upon the liquidation of Eastern Shore.

The facts of this case have been fully stipulated pursuant to Rule 122. The stipulations of fact and joint exhibits attached are incorporated herein by this reference.

Petitioner Carlton L. Byrd (Byrd), resided in Onancock, Virginia, and petitioner Robert H. Willey, Jr. (Willey), resided in Fargo, North Dakota, when the petition in this case was filed.

B & W, Inc., was organized on June 21, 1976, under the laws of the Commonwealth of Virginia. The corporate name was subsequently changed to Eastern Shore Nursery of Virginia, Inc. Its principal place of business was Kerr, Virginia. The stock of Eastern Shore was owned 50 percent by Byrd and 50 percent by Willey. Byrd and Willey (petitioners) operated Eastern Shore, a nursery, as an electing small business corporation from June 24, 1976, through March 29, 1980.

Eastern Shore kept its books and filed its returns on the accrual method of accounting. For tax purposes, Eastern Shore did not maintain an inventory of plants but rather expensed its cost of inventory on a yearly basis as if it were a cash basis taxpayer. For financial and book purposes, Eastern Shore maintained an ongoing yearly inventory of its plants. During the taxable years 1976, 1977, 1978, and 1979, Eastern Shore filed Forms 1120 on a calendar year basis.

On March 29, 1980, petitioners entered into an agreement (the agreement), with a general partnership known as Eastern Shore Nursery of Virginia (the partnership), an organization totally unrelated to Eastern Shore or to petitioners. Pursuant to the agreement, petitioners sold all of the outstanding stock of the corporation to the partnership. Concurrently with this sale, the partnership liquidated Eastern Shore pursuant to section 331 and section 336. Pursuant to the liquidation all of Eastern Shore's assets were distributed in kind to its shareholder, the partnership.

On March 29, 1980, Eastern Shore had on hand and distributed to the partnership in liquidation all of its unsold plant inventory. While the plant inventory had a book value of $244,880, its tax basis was zero because the plants had been previously expensed. On that same day, Eastern Shore had on hand and distributed to the partnership in liquidation an inventory of supplies which had been previously expensed in the amount of $33,225.

The agreement also assigned a fair market value to each of the corporation's assets as follows:

Cash	$25
Accounts receivable	47,369
Plant inventory	450,517
Supplies	33,225
Equipment	57,365

The partnership claimed a stepped-up basis in the assets it received upon liquidation by allocating the purchase price of the stock proportionately to the assets received based upon their respective fair market values. The plant inventory was allocated a basis of $450,517. At present, the partnership continues to operate the nursery.

In the notices of liability issued to petitioners, respondent determined that expenses previously deducted by the corporation in the amount of $278,105 are recoverable pursuant to section 111.[2] Of that amount, $33,225 is related to the cost of supplies which had been deducted but which remained unused when Eastern Shore liquidated. The parties have stipulated that petitioners are liable for the tax which results from the application of section 111 to the $33,225 of unused supplies.[3]

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[2] The notices of liability state "It is determined that expenses previously deducted, in the amount of $278,105.00, are recoverable under section 111 of the Internal Revenue Code."

The stipulation of facts state in paragraph 24, "The sole issue before the Court is whether the $244,880.00 of previously expensed inventory relating to the unsold plants is recoverable under I.R.C. §111."

As we read section 111 it does not affirmatively provide for the recovery of anything; it excludes from gross income income attributable to the recovery of items previously deducted which did not produce a tax benefit. It is a limitation on the tax benefit rule, which originated in the courts. See note 8 at 377 of the majority opinion in *Hillsboro National Bank v. Commissioner* and *United States v. Bliss Dairy, Inc.*, 460 U.S. 370 (1983), and the concurring and dissenting opinion of Justice Stevens in that case.

We are concerned with the tax benefit rule here.

No part of the deficiency in corporate income tax due from the transferor, together with interest thereon as provided by law, has been paid.

We must determine whether Eastern Shore's distribution of its plant inventory to its sole shareholder, the partnership, upon liquidation requires it to report, as income on its final return, $244,880 of previously deducted plant inventory. Our determination rests upon the application of the tax benefit rule to these particular circumstances.

Petitioners contend the tax benefit rule discussed in *Hillsboro National Bank v. Commissioner* and *United States v. Bliss Dairy, Inc.*, 460 U.S. 370 (1983) (hereinafter cited as *Bliss Dairy*), is to be applied to require that amounts deducted in an earlier year be included in income only when an event occurring in a subsequent tax year is fundamentally inconsistent with the premise on which the prior year's deduction was based. Petitioners contend that in applying this test of "fundamental inconsistency," the Supreme Court has stated that the focus must be on the purpose and function of the provisions allowing the prior year's deduction. Petitioners allege if the purpose for the deduction is thus accomplished in the year of the deduction, then a subsequent event leading to a recovery in a later year will not be fundamentally inconsistent with the deduction. Petitioners contend further that since the purpose for Eastern Shore's expensing the cost of growing plants was accomplished in the tax year ending March 29, 1980, the subsequent liquidation of Eastern Shore was not a fundamentally inconsistent event. Therefore, petitioners conclude that the cost of the previously expensed plant inventory is not recoverable under section 111 or the tax benefit rule.[4]

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[3] Petitioners also concede that they are liable for the tax resulting from Eastern Shore's understatement of gain on the sale of sec. 1245 assets by $9,670.

[4] Petitioners do not contend there must be actual recovery to make the tax benefit rule applicable or that the rule is not applicable in a liquidation. These arguments were both answered in *Bliss Dairy*.

To the contrary respondent contends that the tax benefit rule overrides the nonrecognition provisions of section 336 and requires the corporation to include the $244,880 of previously expensed inventory in income. Respondent argues the deduction allowed to Eastern Shore for the plants was premised on the assumption that the plants would be sold by the corporation in the ordinary course of business. The plants were instead distributed in liquidation. Respondent contends the liquidation distribution was fundamentally inconsistent with the premise upon which the deduction was based. Therefore, respondent concludes that his determination should be sustained.

The tax benefit rule is a judicially created doctrine that has been embodied in part in section 111.[5] The tax benefit rule avoids distortion of income by requiring that if an item is deducted in one year but recovered in a later year it must be included in income in the later year to the extent of the recovery. See, e.g., *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), affd. sub nom. *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir. 1940); Plumb, The Tax Benefit Rule Today, 57 Harv. L. Rev. 129 (1943).

The Supreme Court discussed the tax benefit rule most recently in the consolidated cases of *Hillsboro National Bank* and *Bliss Dairy*.[6] In *Bliss Dairy*, a closely held corporation, a cash basis taxpayer, was engaged in the operation of a dairy. The corporation purchased cattle feed for use in its operations and deducted in its current taxable year the full cost of the feed pursuant to section 162. At the end of that taxable year, a substantial amount of the feed was still on hand. Two days into its next taxable year, the corporation adopted a plan of liquidation and distributed its assets, including the cattle feed, to its shareholders. The shareholders continued to operate the dairy. Relying on section 336, the corporation reported no income from the distribution. The Supreme Court held that the distribution to the shareholders was a nonbusiness use that was inconsistent with a deduction under section 162 for an ordinary and necessary business expense. The Court also held that the tax benefit rule overrode the nonrecognition provisions of sections 336 and 337. Therefore, the corporation had to include in income the amount of the unwarranted deduction; the amount being that portion of the cost of the grain attributable to the amount on hand at the time of liquidation. The test utilized by the Court in determining whether the tax benefit rule required Bliss Dairy to recoup income from its prior deduction was whether the distribution to its shareholders upon liquidation was "fundamentally inconsistent with the premise on which the deduction was initially based." *Bliss Dairy*, 460 U.S. at 383. The Court therefore conducted an examination of the purpose and function of section 162. *Bliss Dairy, supra.*

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[5] Sec. 111 provides in part as follows:

SEC. 111. RECOVERY OF TAX BENEFIT ITEMS.

(a) DEDUCTIONS.—Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amounts did not reduce income subject to tax. * * *

[6] *Bliss Dairy* actually involved two cases; one involving Hillsboro National Bank and one involving Bliss Dairy, Inc. Our focus will be upon the case involving Bliss Dairy, Inc., since it is factually similar to the instant case.

The parties agree that the decision in *Bliss Dairy* and the principles stated therein are determinative for our purposes. However, the parties disagree upon the result reached when the principles of *Bliss Dairy* are applied to the instant case. Petitioners contend that when the purpose and function of the code provision granting the deduction herein is examined, the later distribution of the plant inventory to the shareholders does not prove to be fundamentally inconsistent with the prior deduction. Petitioners contend that our focus should be on section 352 of the Revenue Act of 1978 (hereinafter referred to as act section 352). Act section 352 provided that farmers, nurserymen, and florists utilizing the accrual method of accounting who were not required by section 447 to capitalize preproductive period expenses, could not be required to inventory growing crops. Petitioners contend the purposes behind act section 352 were (1) to allow taxpayers to avoid the difficulty of maintaining inventory records of growing crops; and (2) a recognition that the effect of weather and disease make it difficult to ascertain the amount and value of crops on hand at the beginning of each taxable year. Petitioners contend that these purposes were accomplished by allowing Eastern Shore to expense its costs for plants. Since the legislative purposes behind act section 352 were accomplished during the taxable years in question, petitioners argue, the subsequent liquidation of Eastern Shore and distribution of its assets had independent significance and was not fundamentally inconsistent with the prior deduction.

Respondent however contends that petitioners have lost sight of the fact that the deduction in the earlier year authorized by section 162 is premised on the fact that an expense is necessary to produce income in the ordinary course of one's business. Respondent asserts that expenses incurred by nurserymen in growing plants are deductible because the plants will be sold to customers in the ordinary course of business. Therefore respondent concludes that since the plants were distributed to shareholders in liquidation this treatment was fundamentally inconsistent with the purpose behind the section 162 deduction. For the reasons set forth below, we agree with respondent.

Section 352 of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2846-2847, provided as follows:

> (a) APPLICATION OF SECTION.–This section shall apply to a taxpayer who–
>
> (1) is a farmer, nurseryman, or florist,
>
> (2) is on an accrual method of accounting, and
>
> (3) is not required by section 447 of the Internal Revenue Code of 1954 to capitalize preproductive period expenses.
>
> (b) TAXPAYER MAY NOT BE REQUIRED TO INVENTORY GROWING CROPS.–A taxpayer to whom this section applies may not be required to inventory growing crops for any taxable year beginning after December 31, 1977.
>
> (c) TAXPAYER MAY ELECT TO CHANGE TO CASH METHOD.–A taxpayer to whom this section applies may, for any taxable year beginning after December 31, 1977 and before January 1, 1981, change to the cash receipts and disbursements method of accounting with respect to any trade or business in which the principal activity is growing crops.
>
> (d) SECTION 481 OF CODE TO APPLY.–Any change in the way in which a taxpayer accounts for the costs of growing crops resulting from the application of subsection (b) or (c)–
>
> (1) shall not require the consent of the Secretary of the Treasury or his delegate, and
>
> (2) shall be treated, for purposes of section 481 of the Internal Revenue Code of 1954 as a change in the method of accounting initiated by the taxpayer.
>
> (e) GROWING CROPS.–For purposes of this section, the term 'growing crops' does not include trees grown for lumber, pulp, or other nonlife purposes.
>
> [92 Stat. 2846-2847 (1983).]

Act section 352 made section 447 applicable to nurserymen, and others as noted. This change thus allowed nurserymen the more favorable accounting treatment of utilizing the accrual method of accounting without inventorying growing crops. See Staff of Joint Comm. on Taxation, General Explanation of the Revenue Act of 1978 at 203 (J. Comm. Print 1979) (hereinafter cited as General Explanation). In addition, nurserymen eligible to use an accrual method of accounting could elect, without prior Internal Revenue Service approval, to utilize the cash method of accounting. See General Explanation, *supra*.

Act section 352 did not change the nature of deductions available to nurserymen, or the purpose and function of such deductions. The changes made by act section 352 were changes in timing; changes in accounting treatments. Deductions taken by nurserymen and farmers are governed by section 162 which is the test for all deductions incurred by a taxpayer in a trade or business. We find the facts of *Bliss Dairy* similar to those in the instant case and view *Bliss Dairy* as controlling for our purposes. We must therefore examine the purpose and function of section 162 in light of petitioners' deductions to determine whether the distribution to Eastern Shore's shareholder in liquidation was "fundamentally inconsistent with the premise on which the deduction was initially based."

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred by the taxpayer during the taxable year in carrying on a trade or business. Only net income derived from conduct of the business is subject to taxation. Farmers or nurserymen engaged in the production of crops which take more than 1 year to produce from the time of planting may deduct expenses pursuant to the crop method in the taxable year in which income from the crop is realized, or the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided a consistent practice of deducting such costs as an expense from year to year is followed. Sec. 1.162-12(a), Income Tax Regs. If the purchased plants are not sold in the ordinary course of the taxpayer's trade or business, but are instead converted to a nonbusiness use which does not produce business income, this action would be viewed as inconsistent with the prior deduction, and the tax benefit rule would require that an amount equal to the unwarranted deduction be included in income. See *Bliss Dairy, Inc. v. United States*, *supra* at 1149.

Such is the situation in the instant case. Petitioners deducted the cost of young plants purchased for sale in their business after the plants had grown to mature size. Instead of selling the plants in the ordinary course of their trade or business and realizing income to offset the cost of production, petitioners distributed the plants to its shareholder in liquidation. It is clear that this treatment is "fundamentally inconsistent" with the purpose for which the deduction was taken. Pursuant to section 162(a), the deduction for young plants purchased in the ordinary course of business is allowed with a view to recouping this expense when the plants reach maturity and are thereafter sold. Therefore, the original cost of the plants is matched with the later income from the harvest of the crop. *Bliss Dairy*, *supra*; *Ballou Construction Co. v. United States*, 611 F. Supp. 375 (D. Kan. 1985); see also sec. 1.162(a)-12, Income Tax Regs. While the timing of their tax treatment is governed by section 447 which was amended by section 352, the authority for petitioners' deductions lies in section 162. Since petitioners distributed the plants to their shareholders in liquidation, the tax benefit rule requires that they include in income the amount of their unwarranted deduction.[7]

To reflect the foregoing,

Decision will be entered for the respondent

E. ROGER FRISCH AND MARIE L. FRISCH, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9417-83. Filed October 28, 1986.

Petitioner, an attorney acting pro se, prevailed in a Tax Court case involving the valuation of a donated Norman Rockwell print. He then moved for an award of reasonable

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[7] See also *Gorton v. Commissioner*, T.C. Memo. 1985-45.

litigation costs pursuant to sec. 7430, I.R.C. 1954. *Held*, respondent's position in the Tax Court proceeding was unreasonable, and petitioner is entitled to litigation costs. *Held, further*, a pro se attorney-petitioner is not entitled to an award for the value of his own services. *Held, further*, petitioner is awarded the sum of $1,860, representing expert witness fees and the fee for filing his Tax Court petition.

E. Roger Frisch, pro se.
Patrick Turner, for the respondent.

OPINION

PARR, *Judge*: This matter is before us on petitioners' motion for litigation costs. The issues are: (1) Whether the position of the United States in the civil proceeding was unreasonable, and if so, (2) whether a pro se attorney-petitioner may be compensated for the value of services rendered in his own behalf, and (3) what amount of litigation costs should be awarded. The second issue is one of first impression in this Court.

Respondent determined a deficiency in Federal individual income tax against petitioners for 1979 in the amount of $6,506, and an addition to tax under section 6653(a)[1] in the amount of $325. Respondent also sought increased interest on underpayments attributable to tax motivated transactions under section 6621(d).

This case was tried in New York City on January 14, 1986. Before trial, respondent conceded an issue related to a mining partnership. The issues tried (charitable contribution deduction, negligence, and additional interest) all turned on the value of a hand-signed Norman Rockwell print donated by petitioners[2] to Bates College in December 1979.

Petitioners purchased the print at an auction in New York on March 20, 1974, for $1,150. Respondent contended the print was worth $500 when donated. Petitioner claimed $6,000. Following trial, we rendered oral findings of fact and opinion pursuant to section 7459(b) and Rule 152, and found for petitioners. A decision was entered for petitioners on

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Petitioner Marie L. Frisch is a party only by virtue of having signed a joint return. Roger Frisch will hereafter be referred to as petitioner.

February 26, 1986. Also on that date, copies of a transcrip of our oral findings of fact and opinion were served on th parties by the Clerk pursuant to Rule 152(b). Petitioner then filed their motion for litigation costs and on March 28 1986, we vacated our decision,[3] and ordered respondent t file a response. No party requested a hearing, and s pursuant to Rule 232(a)(3), we decide the motion without hearing.[4]

Section 7430 provides, in pertinent part, that a taxpaye who has substantially prevailed in a civil tax proceedin may be awarded a judgment for reasonable litigation cost if he establishes that respondent's position in the proceeding was unreasonable. Petitioners have the burden o establishing unreasonableness. See *DeVenney v. Commissioner*, 85 T.C. 927, 928-930 (1985).

Here petitioners prevailed both with respect to th amount in controversy and to the issues presented. Respondent has not addressed whether petitioners have exhauste their administrative remedies as required by sectio 7430(b)(2). We find they have. At issue is whether respondent's position was unreasonable.[5]

Reasonableness of Respondent's Position

The record herein reveals that respondent relied on a appraisal which was thoroughly discredited at trial. Th appraisal erroneously implied that prices fell afte Rockwell's death when in fact they rose precipitously. I also omitted higher-priced comparables, indicatin Rockwell's paintings sold at between $4,250 and $9,000 when sales prices really ranged from $4,250 to $65,000. W are convinced respondent was alerted to these defects in his expert's report and should have investigated further, especially since he had petitioner's appraisal 7 months before trial. Respondent's failure to investigate petitioner's claims or to re-evaluate his own position as new facts came to light was unreasonable. See *Baker v. Commissioner*, 788 F.2d 38 (D.C. Cir. 1986); *Golden v. United States*, an unreported case (W.D. Mo. 1986, 86-2 USTC par. 9626). Cf. *DeVenney v. Commissioner*, 85 T.C. 927 (1985) (respondent's lack of evidence not unreasonable where petitioner did not give respondent sufficient time to follow leads which would have supported petitioner's explanation).

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[3] Sec. 7430(e) provides that an order granting or denying an award for reasonable litigati costs shall be incorporated as part of the decision and shall be subject to appeal in the sa manner as the decision. We therefore vacated our decision of Feb. 26, 1986, so that we co incorporate such order.

[4] We decline to interpret as a motion for a hearing petitioner's statement, made alm incidentally as part of an unrelated discussion in his reply memorandum, that he would lik examine respondent's appeals officer under oath "if he made [statements respondent attribu to him]."

[5] We have previously held that only respondent's post-petition conduct, and not h pre-litigation administrative conduct, may be scrutinized for unreasonableness. *Wasie* *Commissioner*, 86 T.C. 962 (1986), and cases cited therein. Accord *United States v. Balanc* *Financial Management, Inc.*, 769 F.2d 1440 (10th Cir. 1985). Contra *Powell v. Commissione* 791 F.2d 385 (5th Cir. 1986), revg. and remanding T.C. Memo. 1985-27; *Kaufman v. Egger*, 7 F.2d 1 (1st Cir. 1985). The Court of Appeals for the Second Circuit, to which this case appealable, has not ruled on the point.

In addition, respondent sought answers from petitioner to a long list of informal interrogatories which were not only burdensome but, more importantly, in large part unrelated to the issues in dispute. After the petition in this case was filed, respondent adopted an inflexible attitude which effectively rejected any settlement negotiations despite petitioner's sustained efforts to engage in such negotiations in a meaningful fashion. Instead, respondent clung to his original position that the painting was worth only $500, less than half the actual cash price petitioner had paid in an arm's-length purchase 5 years earlier. Respondent continued to press a claim of negligence up to and throughout trial, when all evidence pointed to the opposite result.

Under these circumstances, we conclude that respondent consistently adhered to a trial strategy designed to persuade petitioner to capitulate *despite the merits of the case.* This is unreasonable. The legislative history of section 7430 instructs us to consider as a factor in determining unreasonableness "whether the government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case." H. Rept. 97-404, at 12 (1981).

Fees for Pro Se Attorney/Petitioner

Section 7430(c)(1)(A), which permits the award of reasonable litigation costs, reads as follows:

> (A) IN GENERAL.—The term "reasonable litigation costs" includes—
> (i) reasonable court costs,

(ii) the reasonable expenses of expert witnesses in connection with the civil proceeding,

(iii) the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and

(iv) reasonable fees paid or incurred for the services of attorneys in connection with the civil proceeding.

Petitioner is an attorney who appeared on his own behalf. He seeks an award of $1,800 for expert witness fees and $6,000 in attorneys fees representing his own time preparing his case. Respondent concedes the amount claimed for the expert witness is reasonable, and we so hold.

Although petitioner failed to separately list court costs, we take judicial notice of the fact that the fee for filing a petition in the Tax Court on April 25, 1983, when the petition was filed, was $60. We find as a fact that petitioner incurred this court cost.

We hold that petitioner is entitled to an award of $1,860 in litigation costs representing the services of the expert witness and the cost of filing the petition.

We turn now to petitioner's claim of $6,000 for his own services. We note at the outset that the amount petitioner seeks does not fall under court costs, expert witness fees, o reports. To prevail, therefore, he must bring himself withi the language of sec. 7430(c)(1)(A)(iv), "reasonable fees paid or incurred for the services of attorneys in connection wit the civil proceeding." Petitioner did not *pay* fees to any other attorney. We must therefore decide whether the tim spent by petitioner on his own case (when he might instea have been working on a client's case and therefore generat ing income) is a "fee incurred" for the services of a "attorney" within the meaning of the statute. We hold it i not.

Whether a pro se attorney/petitioner may receive atto neys fees for the value of his own services rendered on h own behalf is an issue of first impression under sectio 7430;[6] neither has this specific issue been decided under th Equal Access to Justice Act, 28 U.S.C. sec. 2412 (198 (EAJA).[7]

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[6] The issue was raised but not reached in *Popham v. Commissioner*, T.C. Memo. 1984-

[7] In the context of pro bono representation, several courts have found that under the EA legal fees need not be actually incurred to be awarded. See, e.g., *Ceglia v. Schweiker*, 56

Petitioner urges us to follow the reasoning of courts which have allowed attorneys fees to pro se litigants under the Civil Rights Attorneys Fees Awards Act of 1976, 42 U.S.C. sec. 1988 (1982). See, e.g., *Duncan v. Poythress*, 777 F.2d 1508 (11th Cir. 1985), and *Ellis v. Cassidy*, 625 F.2d 227 (9th Cir. 1980).[6]

In *Duncan v. Poythress, supra*, the Court of Appeals reversed the District Court's denial of fees for a pro se attorney-plaintiff on the following grounds:

(1) The absence of any express prohibition in the statute strongly suggests that fee awards should be allowed, unless there is legislative history which provides otherwise;

(2) An attorney representing himself is precluded from other employment while so engaged and clearly suffers a pecuniary loss while preparing and prosecuting the claims in question;

(3) The purpose of the statute is furthered by encouraging attorneys to vindicate important policies;

(4) It would be anomalous to reason that the plaintiff could have recovered attorneys fees had she retained other counsel, but that she should be denied recovery for her representing herself.

Because of differences in the language of 42 U.S.C. sec. 1988 (1982) and sec. 7430, which is the subject of the instant case, the majority opinion in *Duncan* is of questionable precedential value for us. The language of 42 U.S.C. sec. 1988 is as follows:

Supp. 118 (E.D. N.Y. 1983). However, the language of the EAJA is not limited to fees "paid or incurred" as in sec. 7430, but permits "costs," "reasonable fees and expenses of attorneys," and "fees and other expenses, in addition to any costs awarded." The issue of fees for pro bono representation is not before us, and we express no opinion on that matter.

[6] The Court of Appeals for the Second Circuit, to which this case is appealable, has also awarded attorneys fees under 42 U.S.C. sec. 1988 (1982) to pro se attorneys. See *Mid-Hudson Legal Services, Inc. v. G & U, Inc.*, 578 F.2d 34 (2d Cir. 1978). That court reversed the denial of an award to lawyers who obtained an injunction restraining farmers from interfering with the lawyers' education of migrant farm workers as to their legal rights. The key finding was that the attorneys brought suit to vindicate a general Federal policy which that section was enacted to promote. The court held that fees need not be denied merely because the legal theory used was that the plaintiff/attorneys' rights had been violated, not those of the migrant workers. This opinion, however, although apparently binding in the 42 U.S.C. sec. 1988 context, did not analyze the general proposition at issue here, i.e., whether compensable attorney fees include lost opportunity costs.

See also *Rybicki v. State Board of Elections*, 584 F. Supp. 849 (N.D. Ill. 1984) (three-judge panel granting fees); contra *Lawrence v. Staats*, 586 F. Supp. 1375 (D. D.C. 1984) (fees denied).

> In any action or proceedings to enforce a provision of [the Civil Rights
> Act of 1964], the court, in its discretion, may allow the prevailing party,
> other than the United States, a reasonable attorney's fee as part of th
> costs.

We note the absence of any requirement that such a fee b
actually *paid* or *incurred*, as is required by sec. 7430.

Judge Roney's dissent in *Duncan*, however, is highl
relevant to our inquiry. He focused on the meaning of th
word "attorney":

> Although the majority believes the "plain language" of section 198
> "does not preclude an award of fees to a lawyer representing herself," w
> have simply been unable to find any definition which permits a decisio
> that a *pro se* lawyer has an attorney. Set forth in an Appendix to th
> opinion are the definitions found in over two dozen dictionaries. Withou
> exception they define the word "attorney" in terms of someone who ac
> for *another*, someone who is employed as an agent to represent *anoth*
> someone who acts at the appointment of *another*. A basic principle
> agency law is that "[t]here is no agency unless one is acting for and
> behalf of *another*, since a man cannot be the agent of himself." 2A C.J.
> *Agency* §27, at 592. For there to be an attorney in litigation there mu
> be two people. * * * The fact that such plaintiff is admitted to practi
> law and available to be an attorney for others, does not mean that t
> plaintiff has an attorney, any more than any other principal who
> qualified to be an agent, has an agent when he deals for himself. In oth
> words, when applied to one person in one proceeding, the terms "*pro s*
> and "attorney" are mutually exclusive. [*Duncan v. Poythress*, 777 F.2d
> 1518 (dissenting opinion). Emphasis in original.]

Fees were denied in *Lawrence v. Staats*, 586 F. Sup
1375 (D. D.C. 1984). The court cited numerous cases whe
other circuits overwhelmingly concluded that pro se (non
torney) plaintiffs are not entitled to attorneys fees under
U.S.C. section 1988.[9] The court found no principled disti
tion between the lost opportunity costs of pro se non
torneys, who cannot recover fees, and pro se litigants w
happen to be lawyers. 586 F. Supp. at 1379. But
Duncan v. Poythress, 777 F.2d at 1513-1514.

Courts have split on the award of fees to pro se attorn
in Freedom of Information Act cases (FOIA), where "
court may assess the United States reasonable attorn

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[9] *Pitts v. Vaughn*, 679 F.2d 311, 312-313 (3d Cir. 1982); *Wright v. Crowell*, 674 F.2d 521,
(6th Cir. 1982); *Cofield v. Atlanta*, 648 F.2d 986, 987-988 (5th Cir. 1981); *Lovell v. Snow*,
F.2d 170, 171 (1st Cir. 1981); *Davis v. Parratt*, 608 F.2d 717, 718 (8th Cir. 1979); *Owens-*
Robinson, 496 F. Supp. 877, 878-880 (W.D. Pa. 1980), affd. 694 F.2d 941 (3d Cir. 1
Rheuark v. Shaw, 477 F. Supp. 897, 928 (N.D. Tex. 1979).

fees and other litigation costs reasonably incurred in any case under this section in which the complainant has substantially prevailed." 5 U.S.C. sec. 552(a)(4)(E) (1982). See, e.g., *Falcone v. IRS*, 714 F.2d 646 (6th Cir. 1933), cert. denied 466 U.S. 908 (1984) (fees denied); *Cazalas v. United States Department of Justice*, 709 F.2d 1051 (5th Cir. 1983) (fees granted); *Cuneo v. Rumsfeld*, 553 F.2d 1360 (D.C. Cir. 1977) (fees granted). In at least one circuit, the FOIA provision has been construed to allow lay persons to obtain "attorneys" fees for their own efforts in FOIA litigation. See *Cox v. United States Department of Justice*, 601 F.2d 1 (D.C. Cir. 1979). Focusing on the specific language of 5 U.S.C. sec. 552(a)(4)(E) (1982), the Court of Appeals for the District of Columbia Circuit has held that foregone income is an "other litigation [cost] reasonably incurred." *Cuneo v. Rumsfeld, supra* at 1366. The Fifth Circuit in *Cazalas* followed that interpretation of the statutory language, but refused to extend the reasoning to pro se nonattorney litigants, noting the difficulty in computing the worth of their "legal" services.

Respondent urges us to adopt the reasoning of the Court of Appeals for the Sixth Circuit, which denied fees to pro se attorneys in FOIA cases.[10] In *Falcone v. IRS, supra*, the court cited three reasons for its denial of fees. First, pro se attorneys do not incur legal costs in representing themselves, and, therefore, never assume the burden Congress intended to ease by the fee provisions. Second, FOIA was intended to encourage potential claimants to seek legal advice before starting litigation which might prevent unnecessary litigation, noting that a pro se attorney is unlikely to have the "detached and objective perspective" necessary to fulfill the aims of the act. Finally, the court was concerned that awarding attorneys fees to pro se plaintiffs may create a "cottage industry" for claimants using the act as a way to generate fees rather than to vindicate legitimate claims.

While some of these arguments are more persuasive in the FOIA setting than in tax litigation, we need not pick and choose among them. The simple truth is that the plain language of section 7430 cannot be read to include lost opportunity costs, but is limited to actual expenditures. The legislative history supports our conclusion:

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[10] See also *White v. Arlen Realty & Dev. Corp.*, 614 F.2d 387 (4th Cir. 1980), cert. denied 447 U.S. 923 (1980) (fees denied pro se attorney in Truth-In-Lending Act case).

> The determination of what constitutes a reasonable amount for the expenses, costs, and fees *actually* incurred by a taxpayer in a civil tax action is to be made by the court hearing the action. [H. Rept. 97-404, at 14; emphasis supplied.]

Unlike the Civil Rights Attorneys Fees Awards Act, which provides for allowance of "a reasonable attorney's fee as part of the costs," or the FOIA provision which permits payment of "other litigation costs reasonably incurred," section 7430 is more narrowly drawn. The term "reasonable litigation costs" includes only court costs, expert witness expenses, costs of a study or report, and "reasonable fees *paid or incurred for the services of attorneys.*" (Emphasis added.)

The plain language of the statute controls here in two respects. First, we adopt the reasoning of Judge Roney in his dissenting opinion in *Duncan v. Poythress, supra.* An "attorney" is essentially an agent for another. Without the "other" there can be no attorney, merely a pro se litigant who happens to earn a living as a lawyer. At any given time, an individual can be either a pro se litigant or an attorney, but not both.[11]

Second, petitioner did not pay or incur fees for legal services. Admittedly, he did not pay any money for such services. The common meaning of the word incur is "to become liable or subject to: bring down upon oneself." See Webster's Ninth New Collegiate Dictionary 611 (1985); Webster's New International Dictionary of the English Language 1261 (2d ed. 1958). In representing himself, petitioner did not become liable to another person for attorney fees nor did he bring down upon himself any debt. We therefore hold that petitioner is barred by the plain language of the statute from recovering compensation for his own time spent in litigating his own case.

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[11] Our analysis is not changed by sec. 7430(c)(1)(B) which defines attorneys to include individuals authorized to practice before this Court, whether or not they are lawyers. Sec. 7452 and Rule 200 describe those admitted to practice before this Court. A different Rule allows pro se petitioners to represent themselves and also allows other narrowly defined classes of representatives to appear. See Rule 24. We interpret sec. 7430(c)(1)(B) to be applicable only to those authorized to represent another, and not to those appearing on their own behalf. The language "fees for the services of an individual," supports our conclusion.

Petitioner appeared on behalf of himself and Marie L. Frisch regarding their joint liability. We need not consider the effect of such appearance, since there is no evidence or claim that she paid or incurred fees for such service.

Petitioner actually paid or incurred $1,800 for an expert witness fee and $60 court costs. These amounts are reasonable, and we award them to petitioner. We do not believe the statute allows us to reimburse petitioner for his lost time.

To reflect the foregoing,

An appropriate order and decision will be entered.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, and WILLIAMS, *JJ.*, agree with this opinion.

GERBER, and WELLS, *JJ.*, did not participate in the consideration of this opinion.

DON CASEY CO., INC.; CHARLES DON CASEY, SOLE SHAREHOLDER OF DON CASEY CO., INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 42107-84. Filed October 28, 1986.

The Commissioner determined that the DC Co. owed certain deficiencies and that it was liable for the addition to tax for fraud under sec. 6653(b), I.R.C. 1954. The parties agreed that the statute of limitations had run unless the Commissioner proved fraud. After the trial, the Court rendered a bench opinion announcing that the Commissioner had failed to prove fraud and that therefore the company was not liable for the deficiency. Thereafter, the company filed a motion for reimbursement of its litigation costs under sec. 7430, I.R.C. 1954. *Held*, in pursuing the litigation in this Court, the Commissioner was unreasonable within the meaning of sec. 7430, I.R.C. 1954, and consequently, the company is entitled to reimbursement of its litigation costs.

Howard A. Weinberger, for the petitioner.
William P. Hardeman, for the respondent.

OPINION

SIMPSON, *Judge*: This matter is now before us on motion by the petitioner for reimbursement of its litigatio costs under section 7430 of the Internal Revenue Code 1954.[1] The principal issue for decision is whether th Commissioner was unreasonable within the meaning of tha section in pursuing the litigation in this Court.

The petitioner, Don Casey Co., Inc. (the company), was Texas corporation with its principal office located in Ga land, Texas. The company's corporate charter was revoke on August 10, 1983, by the secretary of state of the Sta of Texas, and it has been inactive and defunct since tha time. Charles Don Casey is the sole shareholder of th company and resided in Dallas, Texas, at the time th petition was filed in this case.

The company filed its Federal corporate income tax retur on the basis of a fiscal year ending March 31, and it fil its Federal income tax return for the fiscal year endi March 31, 1980, with the Internal Revenue Service Cent Austin, Texas. The company maintained its books a records and filed its Federal income tax returns by use the accrual method of accounting. We will sometim identify the company's taxable year by reference to the ye in which it ends.

The company was in the silver reclamation business. recovered silver from used film and processed it into silv bars. It also purchased silver scrap from other processe and silver bars which needed further refining. All silver w sold as silver bars.

In late 1981 or early 1982, the Internal Revenue Servi commenced a criminal investigation of the company as result of a confidential report that the company h willfully omitted income in excess of $2 million. The I issued a summons to Mr. Casey to produce the books a records of the company. His attorney, Howard Weinberger, advised the IRS that the records would made available in his office. Two special agents, including Russell Shelton, came to Mr. Weinberger's office on March 17, 1982, and all of the records then possessed by Mr. Weinberger, including the general ledger of the company, were made available to the special agents. The agents removed many of the records, but they did not take the general ledger. Mr. Shelton conducted the investigation, and he does not remember seeing the complete general ledger until shortly before the trial.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during year in issue, unless otherwise indicated.

Subsequently, the IRS recommended that Mr. Casey be charged with a violation of section 7206(1) for willful filing of a false return. The recommendation was based on the alleged failure to report two sales of silver to a subsidiary of General Motors (GM) in March 1980. The first GM sale was on March 4, 1980, and was for $1,361,243.11. The second GM sale was allegedly on March 31, 1980, and was for $809,470.06. In concluding that those sales were not reported, the agent relied upon a financial statement of the company for March 1980. That statement reported:

Sales - silver bars (rec'd)	$636,180.58
Sales - silver flake (cust)	422,953.47
Sales - silver film flake	554,938.53
Sales - manufactured items	41,545.40
Total sales	1,655,617.98

On November 15, 1983, Mr. Weinberger met in Washington, D. C., with an attorney representing the Department of Justice. At that meeting, Mr. Weinberger took the position that the first GM sale had in fact been recorded in the general ledger and included in the reported income. In support of his position, he produced excerpts from the general ledger showing that such sale was recorded as having occurred on March 4, 1980. He also took the position that the second GM sale was not reported for 1980 because the price was not agreed upon until after March 31, 1980. The Justice attorney asked whether Mr. Weinberger would agree to a further investigation, and Mr. Weinberger agreed. The special agent was contacted by the Justice attorney and told of Mr. Weinberger's position and evidence. Nevertheless, the special agent never made any further investigation; he never requested to see the general ledger, and he never interviewed any other witnesses with respect to the general ledger, nor requested any other documents. Mr. Casey was never charged with any criminal violation.

On November 20, 1984, the Commissioner issued a notice of deficiency to the company in which he determined that the company had omitted $2,406,202.22 from its gross income for 1980 and that the underpayment of tax was due to fraud within the meaning of section 6653(b). In its petition, the petitioner disputed the entire deficiency and its liability for the fraud addition. It alleged that the statute of limitations had run before the issuance of the notice of deficiency. It also alleged that the first GM sale had been reported and that the second GM sale was not reportable for 1980. It alleged that during the latter part of March 1980, the price of silver was fluctuating drastically, that the petitioner and GM agreed that the price of such silver should be computed by "using a ten day average of silver prices both before and after the actual date of transfer of title," and that the price was not determined until after March 31, 1980. In his answer, the Commissioner alleged that the proceeds of the first and second GM sales were not reported, that deposits in the RAD account at the Garland Bank and Trust were not reported, and that sales to Handy and Harman in the amount of $120,167.10, to Rio Grande Jewelers in the amount of $113,095.45, and of telescope scales in the amount of $2,226.50 were not reported. In its reply, the petitioner admitted that deposits were made in the RAD account and that the sales to Handy and Harman and to Rio Grande Jewelers were not reported; it denied for lack of information the allegation concerning the telescope scales.

On June 18, 1985, there was a hearing by an agent of the Appeals Division at which Mr. Weinberger appeared and produced the originals of the general ledger and sales journals for all of fiscal 1980. At that conference, Mr. Weinberger did not explain that the company reclassified sales for purposes of the financial statements. However, the Appeals Officer did not question the validity of the general ledger shown to him, and the explanation of the reclassification would not have altered his conclusion; he accepted the petitioner's return since it reflected the income shown in the general ledger and the proper amount of tax.

The Appeals Officer also requested whether the company would agree to a further examination of its records, and Mr. Weinberger agreed. A revenue agent came to Mr. Weinberger's office on November 25, 1985, and examined the company's records, including the general ledger, for approximately 2 hours.

The case was set for trial at a session of the Court commencing on March 3, 1986. On January 30, 1986, the counsel for the Commissioner advised Mr. Weinberger that he would concede the case, but on February 18, 1986, he reported to Mr. Weinberger that the Regional Counsel had overruled him and that the case would be tried.

At the trial, the general ledger of the company was admitted in evidence and showed that the first GM sale had been recorded. The proceeds of such sale were included in the income of the company for 1980. In connection with the second GM sale, the purchase order stated in part: "Invoice will be average Handy & Harmon of next five market days following quantity release less 1%" and "Invoice will be average Handy & Harmon of preceding five market days prior to shipment less 1%." The silver was delivered to the GM subsidiary on March 31, 1980. The invoice had a typed price of $838,665.37; but that price was crossed out, and a price of $809,470.06 was written in. The change was initialed by an employee of the company, who remembered delivering the silver, remembered that there was some dispute over the price, and remembered that after consulting with Mr. Casey, he initialed the changed price. However, he did not remember whether the new price was inserted on March 31, 1980, or thereafter.

Special Agent Shelton testified and admitted that Michael Furlow, who was the comptroller and financial vice president of the company from July of 1980 until October 1981, told him that the first GM sale had been reclassified, although Mr. Furlow did not know why that was done. Mr. Shelton also admitted that his conclusion that the second GM sale was reportable in 1980 was based solely upon the purchase order and invoice; although the accountants for the company told him that there was some question about when the price was agreed upon and when the sale was completed, Mr. Shelton never interviewed William W. Parmenter, the buyer for the GM subsidiary and the person most familiar with the circumstances surrounding the purchase by such subsidiary, nor did Mr. Shelton interview any employees of the company regarding the circumstances surrounding such sale.

Mr. Furlow, who left the company because he was fired, was called by the Commissioner as his witness. He prepared the workpapers from which the company's 1980 return was prepared, and the proceeds of the first GM sale were included in income and reclassified by him. However, he believed that Mr. Casey withheld the records concerning some bank accounts and that the return did not report all receipts of the company.

Another former employee of the company testified that some sales of silver were made for cash and that he understood that the proceeds of some sales were not recorded in the books of the company. He also testified that on occasion, Mr. Casey commented with respect to the payment of taxes that "he needed it more than the government" and "it was maybe doing him better than the government." Another former comptroller of the company, who was also dismissed, testified that Mr. Casey altered assay records in order to reduce what the company paid for silver. He also said that Mr. Casey ordered that invoices not be written for all cash sales and that all cash sales should not be recorded; according to that employee, Mr. Casey said "that there was no sense paying taxes on everything that was recorded, or everything that came in."

In connection with the second GM sale, Mr. Parmenter testified that the price was to be based upon the average Handy and Harman quotations for the 5 days preceding the sale. However, he admitted that the price was computed by the accounting department of his company. He was asked to compute the price in accordance with his understanding; he excluded the days of March 29 and 30 since they were a weekend; he used the Handy and Harman quotations for March 24 through 28; and he came up with a total price of $641,037. He had no explanation for the difference between that price and the price actually paid by his company. The purchase price was in fact paid on April 9, 1980.[2]

As a witness, Mr. Casey said that there was a bitter domestic dispute between himself and his former wife from 1979 to 1981. He said that she became a co-director of the company and that all checks had to be approved by both of them. She interfered with business decisions and even filed a petition for bankruptcy of the company.

Mr. Casey explained that he directed the accounting department, in preparing the financial statement, to reclassify the first GM sale by reference to the source of the silver. He said that he had historically classified sales by reference to source because the profits differed depending upon the source of the silver.

Mr. Casey testified that the RAD account was established in January 1980; he said that at that time, the difficulties had already developed with his wife and that she was attempting to interfere with the business; he established the RAD account to avoid her interference and to furnish funds that he could use without her knowledge; the account included deposits from the proceeds of the Rio Grande sale, a Handy and Harman sale, and certain smaller sales of silver for cash.

Mr. Casey's wife learned about the RAD account in April or May of 1980. However, Mr. Casey refused to show her the records of the account until she issued a subpoena to have the records produced at a deposition to be taken in December 1980. Shortly before that deposition, Mr. Casey ook the records to his CPA who had prepared the 1980 tax eturn of the company. The CPA pointed out to him that he sales reflected in that account had not been shown on he company's return for 1980. It was decided that Mr. urlow should recompute the sales and tax liability of the ompany. Mr. Furlow reported to Mr. Casey that as a result f other adjustments, the inclusion of the RAD sales did not esult in any increase in tax liability of the company for 980.

At the conclusion of the trial, the Court rendered a bench pinion. In part, the Court stated:

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[2] The company did not report the second GM sale because it became insolvent in 1981 and not file a return for such taxable year.

> Here we have a case in which the Commissioner has determined a deficiency, and an addition to tax for fraud. * * * it is agreed that the statute of limitations on the year at issue, the 1980 fiscal year, has run, if the Commissioner does not show fraud.
>
> Consequently, if there is no showing of fraud, there is no deficiency. * * *
>
> * * * it is * * * well settled that the Commissioner has to prove fraud * * * by clear and convincing evidence. * * *

The Court then reviewed the evidence concerning the first GM sale, the second GM sale, and the RAD account. The Court found that the proceeds of the first GM sale had been included in the income reported by the company for 1980 and that the proceeds were reclassified on the financial statement for business reasons. The Court concluded that the purchase order of the second GM sale was ambiguous as to how and when the price of the silver was to be determined, that under the circumstances, there was a genuine doubt as to when the sale was reportable, and that the failure to report the sale for 1980 was not fraudulent. With respect to the RAD account, the Court recognized that it was established to withhold information from Mr. Casey's wife because of their domestic dispute, that the failure to disclose the records to those preparing the company's tax return may have been negligent, but that such failure was not willful or fraudulent. For these reasons, the Court concluded that the Commissioner had not established fraud by clear and convincing evidence.

After the trial, the petitioner timely made its motion for reimbursement of litigation costs in accordance with Rule 231 of the Tax Court Rules of Practice and Procedure.[3] Thereafter, in accordance with Rule 232, counsel for the parties conferred for the purpose of settling any matters that could be agreed upon, and the Commissioner filed a written objection to the motion. The petitioner then filed its reply to that objection.

Section 7430(a) provides that the prevailing party in any civil proceeding brought by or against the United States in connection with the determination of any tax under the Internal Revenue Code in a court of the United States, including the Tax Court, may be awarded a judgment for reasonable litigation costs. Section 7430(b) provides that an award may not exceed $25,000 and that an award may not be made unless "the prevailing party has exhausted the administrative remedies available to such party within the Internal Revenue Service." A prevailing party is defined by section 7430(c)(2) to mean a party (other than the United States) which establishes "that the position of the United States in the civil proceeding was unreasonable" and that such party—

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[3] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

> (ii)(I) has substantially prevailed with respect to the amount in controversy, or
>
> (II) has substantially prevailed with respect to the most significant issue or set of issues presented.

In his response, the Commissioner concedes that the petitioner has substantially prevailed with respect to the amount in controversy and that the litigation costs claimed by the petitioner, $23,721.60, are reasonable and allowable if the petitioner establishes that it is entitled to an award under section 7430. However, the Commissioner maintains that the petitioner is not entitled to such an award because it did not exhaust its administrative remedies and because it has not established that the position of the Commissioner was unreasonable.

The Commissioner admits that he "may now agree" that the proceeds of the first GM sale were reported in the company's records and on the tax return, but he contends that his conduct was reasonable. He asserts that the general ledger was not produced pursuant to the summons and that the Government lawyers considered the pages from the general ledger which were supplied to the Justice Department to be "fraudulent and counterfeited." The Commissioner's counsel explains that he was willing to settle the case at one time because he was not sure that he could prove the pages to be counterfeit, but the Regional Counsel believed that the case should be presented to the Court to let it decide whether the evidence is trustworthy. The Commissioner's counsel also declares that the petitioner did not reveal the reclassification of the proceeds of that sale before the trial and that he did not learn about it from any other witnesses. With respect to the second GM sale, the Commissioner argues that the purchase order was not

ambiguous, that the price of that sale was determine
March 31, 1980, and that it was based on the Handy
Harman quotations from March 26, 1980, and th
preceding days. Finally, the Commissioner also take
position that the petitioner did not exhaust its admini
tive remedies because, apparently, it did not explain
reclassification to the Appeals Officer. Thus, we
decide what constitutes reasonable conduct by the Com
sioner under section 7430.

The adjudication of this issue requires that it be p
perspective. The treatment of litigation costs in Am
was set forth in *Spencer v. N.L.R.B.*, 712 F.2d 539, 54
(D.C. Cir. 1983):

> Under that longstanding doctrine [the American rule], each l
> ordinarily must pay his own lawyer. *Alyeska Pipeline Service*
> *Wilderness Society*, 421 U.S. 240, 247 * * * (1975). The rule has on
> narrow exceptions: when a loser "has acted in bad faith, vexat
> wantonly, or for oppressive reasons," he may be obliged to reimbu
> winner for his attorneys' fees. *F.D. Rich Co. v. United States*, 41
> 116, 129, * * * (1974) (dicta); accord *Lipsig v. National Student N*
> *ing Corp.*, 663 F.2d 178, 180 (D.C. Cir. 1980) (per curiam); and, w
> individual litigant, by successfully maintaining a suit, has conf
> benefit on a group of persons, the court may allow him to reco
> attorneys' fees from the beneficiaries. *Mills v. Electric Auto-Lite C*
> U.S. 375, 392-97 * * * (1970). Traditionally, the United States w
> less vulnerable to an award of attorneys' fees than a private litig
> the absence of an express statutory provision, even the aforeme
> "bad faith" and "common benefit" rules could not be invoked aga
> federal government. *Pealo v. Farmers Home Administration of the*
> *States Department of Agriculture*, 562 F.2d 744, 748 (D.C. Cir
> (alternative holding); *Rhode Island Committee on Energy v.*
> *Services Administration*, 561 F.2d 397, 405 (1st Cir. 1977). * * *
>
> Since at least the 1920s, the restrictive American doctrine pertai
> the allocation of attorneys' fees has been subjected to persistent
> In the 1960s and early 1970s, federal courts sensitive to these cr
> began to experiment with various alternative, more liberal, fee-
> rules. The most important of these developments was the
> "private attorney general" theory, under which prevailing parti
> allowed to recover attorneys' fees when their suits resulted in
> ment of "important societal rights." In 1975, in the *Alyeska* c
> Supreme Court called a halt to this judicially managed d
> innovation. The Court concluded that, in view of the importa
> complexity of the field and of the history of legislative involveme
> apparent that the circumstances under which attorneys' fees a
> awarded and the range of discretion of the courts in making those
> are matters for Congress to determine." 421 U.S. at 262 * * *

> quently, it held that, in the absence of specific statutory authorization, federal courts sitting in non-diversity cases could award attorneys' fees to prevailing parties only under the established common law exceptions to the American Rule. *Id.* at 247, 257-60, 271 * * *.
>
> The Supreme Court's message was not lost on the legislature. A year after the *Alyeska* decision, Congress passed the Civil Rights Attorney's Fees Awards Act, which allows prevailing parties in suits brought under specified civil rights statutes to recover "a reasonable attorney's fee as part of the costs." The Equal Access to Justice Act, passed four years later, constitutes an even more comprehensive response to the Supreme Court's invitation and self-abnegation. The Act applies to all civil actions brought by or against the United States and allows private prevailing parties to recover attorneys' fees from the government in a wide variety of circumstances.
>
> [Fn. refs. omitted.]

In litigation before this Court, we followed the American rule. In *Key Buick Co. v. Commissioner*, 68 T.C. 178 (1977), affd. 613 F.2d 1306 (5th Cir. 1980), we recognized the general proposition that a petitioner, even though successful, cannot recover his litigation costs in this Court. We examined the Civil Rights Attorney's Fees Awards Act, Pub. L. 94-559, 90 Stat. 2641, and held that it was not applicable to litigation in this Court. 68 T.C. at 179. See *Shapiro v. Commissioner*, 73 T.C. 313 (1979); *Sharon v. Commissioner*, 66 T.C. 515 (1976), affd. per curiam 591 F.2d 1273 (9th Cir. 1978). In *McQuiston v. Commissioner*, 78 T.C. 807, 812 (1982), affd. without published opinion 711 F.2d 1064 (9th Cir. 1983), we considered the Equal Access to Justice Act, Pub. L. 94-481, tit. II, sec. 204(a), 94 Stat. 2327 (28 U.S.C. sec. 2412 (1982)), and held that it does not apply to proceedings in this Court. Thus, it does not authorize this Court to award litigation costs to the prevailing party.

In 1982, Congress decided to experiment with the allowance of litigation costs in tax litigation. It enacted section 7430 and made it applicable to cases commenced after February 28, 1983. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, sec. 292(a), 96 Stat. 324, 572-574. It does not allow all successful petitioners to recover their litigation costs from the Commissioner; in addition to prevailing, a petitioner must show that he exhausted his administrative remedies and that the position of the United States was unreasonable. The legislative

history furnishes some guidelines for determining wh constitutes unreasonable conduct by the Commissioner:

> The committee intends that the determination by the court on this iss is to be made on the basis of the facts and legal precedents relating the case as revealed in the record. Other factors the committee believ might be taken into account in making this determination include, whether the government used the costs and expenses of litigation agai its position to extract concessions from the taxpayer that were justified under the circumstances of the case, (2) whether the governm pursued the litigation against the taxpayer for purposes of harassment embarrassment, or out of political motivation, and (3) such other fact as the court finds relevant. * * * [H. Rept. 97-404, at 12 (1981).]

In further delineation of the test of reasonableness, said in *Baker v. Commissioner*, 83 T.C. 822, 828-829 (198 vacated and remanded on another issue 787 F.2d 637 (D Cir. 1986):

> In any event, the determination of reasonableness should be m based upon all the facts and circumstances surrounding the proceed and the fact that the Government eventually loses the case should no determinative. * * *
>
> Our determination as to whether respondent acted reasonably in case will involve a review of the legal basis for his position and of cer actions taken during litigation. * * *

To recover litigation costs under the Equal Access Justice Act, a successful party must show that the posit of the United States was not "substantially justified." U.S.C. sec. 2412(d)(1)(A) (1982). Several courts have that the "substantially justified" test is in essence a tes reasonableness. *Ashburn v. United States*, 740 F.2d 850 (11th Cir. 1984); *Foster v. Tourtellotte*, 704 F.2d 1 1111 (9th Cir. 1983); *S & H Riggers & Erectors, Inc O.S.H.R.C.*, 672 F.2d 426, 430 (5th Cir. 1982); *U.S. Heydt v. Citizens State Bank*, 668 F.2d 444, 447 (8th 1982). One circuit, that for the District of Columbia, held that the "substantially justified" standard is "slig more stringent." *Spencer v. N.L.R.B.*, 712 F.2d at 558 *Spencer*, the court observed that an attorney for the Un States may have acted reasonably in pursuing litiga but if he was acting pursuant to a directive of his age and if the policy of the agency is unreasonable, a succe party may be awarded his litigation costs. Similarly, agency may reasonably seek the reversal of a precedent, but if it is unsuccessful, the prevailing party may be awarded his litigation costs. Despite those possible differences between the "substantially justified" and the "reasonable" standards, much of the discussion and analysis in the opinions dealing with the Equal Access to Justice Act is helpful in defining the parameters of reasonableness. *Baker v. Commissioner*, 83 T.C. at 828.

The analysis of the Fifth Circuit in *S & H Riggers* is particularly helpful:

> The EAJA was enacted as a three-year experiment in the allocation of the costs of litigation involving the government. The Act rejects the traditional "American rule" of attorney fees according to which fees are not awarded unless the suit was prosecuted in bad faith because otherwise the effect would be to penalize and deter good faith litigation, and moves toward the English rule that the prevailing party ordinarily is awarded the costs of litigation. H.R. Rep. No. 1418, 96th Cong., 2d Sess. 8-10 (1980), reprinted in 1980 U.S. Code Cong. & Ad. News 4953, 4986-88. The premise of the English rule is that a fee award is not a sanction to deter or penalize losing litigation but is a proper allocation of the costs of the litigation and a measure that lifts the cost deterrent facing the successful litigant. * * *
>
> * * * the Act does not adopt the position that the government should compensate all prevailing parties but instead enacts a compromise position embodied in the standard of "substantial justification:"
>
> This standard balances the constitutional obligation of the executive branch to see that the laws are faithfully executed against the public interest in encouraging parties to vindicate their rights.
>
> *Id.* at 10, 1980 U.S. Code Cong. & Ad. News at 4989.
>
> Despite this lack of a precise theoretical underpinning, some practical articulation of the standard can be derived from further discussion in the legislative history. The standard is not as lenient as that governing fee awards against plaintiffs in Title VII suits, where to avoid the award the plaintiff need only show that the case was nonfrivolous, that is, having some justification, merit or foundation. See *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412 * * * (1978). By contrast, under the EAJA, the justification for the government's position must be "substantial." * * * "where a party has had to engage in lengthy administrative proceedings before final vindication of his or her rights in the courts, the government should have to make a *strong showing* to demonstrate that its action was reasonable." H.R. Rep. No. 1418, *supra*, at 10, 18; 1980 U.S. Code Cong. & Ad. News, at 4989, 4997 (emphasis added).
>
> The burden of showing substantial justification for a case that respondents lost is not insurmountable:

> The standard * * * should not be read to raise a presumption that the Government position was not substantially justified, simply because it lost the case. Nor, in fact, does the standard require the Government to establish that its decision to litigate was based on a substantial probability of prevailing.

Id. at 11, 1980 U.S. Code Cong. & Ad. News at 4990. And despite the requirement of a "strong showing" of a substantial justification, the standard is not heightened beyond the requirement that the government show "that its case had a reasonable basis both in law and fact," for "the test of whether or not a government action is substantially justified is essentially one of reasonableness." *Id.* at 11, 1980 U.S. Code Cong. & Ad. News at 4989.

[672 F.2d at 429-430; fn. refs. omitted; emphasis in original.]

In *Spencer v. N.L.R.B.*, *supra*, the District of Columbia Circuit suggested three factors to consider in judging the position of the United States: (1) The clarity of the law, (2) the length and complexity of the litigation, and (3) whether the treatment of the litigant is consistent with the treatment of other persons. 712 F.2d at 559-560. The court considered that if the law is clear, or if the litigation will be lengthy, complex, and expensive, or if the litigant is being treated differently than other persons similarly situated, the United States should bear a heavy burden to justify pursuing the litigation.

In applying these general principles, the courts have held that it was reasonable for the United States to attempt to sustain a Safety and Health regulation which constituted "a novel but credible extension and interpretation of the law." *S & H Riggers & Erectors, Inc. v. O.S.H.R.C.*, 672 F.2d at 431. Similarly, in *Spencer v. N.L.R.B.*, 712 F.2d at 567, the court held that the position of the United States was substantially justified where the interpretation of the N.L.R.B. was "sufficiently plausible." In *Ashburn v. United States*, *supra*, the court concluded that the United States was not unreasonable when it took 11 months to evaluate and concede a complex tax case. In *Baker v. Commissioner*, 83 T.C. 822 (1984), the case was commenced in April 1983, and the Cleveland office of the IRS agreed to concede it in April 1984. The petitioner argued that the IRS was unreasonable in not conceding his case because other similar cases were being settled elsewhere by the IRS. The Tax Court held that the IRS was not unreasonable under such circumstances, but the District of Columbia Circuit remanded because it believed that the Tax Court should consider whether the IRS had a national policy to settle such cases and whether the IRS was unreasonable in delaying the settlement of the petitioner's case. *Baker v. Commissioner*, 787 F.2d 637 (D.C. Cir. 1986). In *DeVenney v. Commissioner*, 85 T.C. 927 (1985), the Commissioner claimed fraud, and this Court held that he had failed to carry his burden of proof; nevertheless, we found that it was not unreasonable for the Commissioner to pursue the litigation because the petitioner did not advise him of the identity of certain key witnesses until shortly before the trial, when there was insufficient time for the Commissioner to interview them. On the other hand, in *United States v. Estridge*, 797 F.2d 1454 (1986), the Eighth Circuit affirmed per curiam the finding of the District Court that the Commissioner had acted unreasonably; the Commissioner had acted contrary to the weight of the evidence and had relied upon the statements of individuals whose testimony was suspect. *Moats v. United States*, 576 F. Supp. 1537 (W.D. Mo. 1984), and 564 F. Supp. 1330 (W.D. Mo. 1983).

The ultimate issue for decision is who should bear the petitioner's costs of pursuing the litigation in this case: the petitioner was successful, and should it bear its own costs of litigation in accordance with the historic American rule; or do the circumstances bring the case within the group of cases with respect to which Congress intended for the burden of the expenses of litigation to be borne by and shifted to the Commissioner. It is the position of this Court that section 7430 is to be applied only to the events occurring during the litigation. *Baker v. Commissioner*, 83 T.C. 822 (1984). The circuit courts are divided on the issue of whether the position of the United States is to be based solely on the events during litigation or whether such position includes an examination of the events occurring before the beginning of the litigation. *Ashburn v. United States, supra*; *Baker v. Commissioner*, 787 F.2d 637 (D.C. Cir. 1986); *United States v. Balanced Financial Management*, 769 F.2d 1440, 1450 (10th Cir. 1985); contra *Powell v. Commissioner*, 791 F.2d 385 (5th Cir. 1986), revg. and remanding a Memorandum Opinion of this Court; *Kaufman*

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v. Egger, 758 F.2d 1, 4 (1st Cir. 1985). Here, we must bear in mind certain events that occurred before the case was commenced: the issuance of the summons, the meeting at Mr. Weinberger's office at which records, including the general ledger, were made available to the Commissioner, and the meeting between Mr. Weinberger and the Department of Justice at which pages from the general ledger were presented to Justice. We must keep those facts in mind in order to know what the Commissioner knew when this case was commenced and to judge his conduct following the filing of the petition. Our holding is based on whether it was reasonable for him to pursue this litigation, taking into consideration what he and his agents knew, and therefore, we base our holding solely on the events that occurred after the case was commenced and do not have to reconsider our position in *Baker*.

Our evaluation of the circumstances of this case leads us to conclude that it was not reasonable for the Commissioner to pursue this litigation and that therefore he should bear the petitioner's costs of litigation. When the law is not clear, it may be reasonable for the Commissioner to pursue litigation that may tend to clarify the law, even though such litigation will be burdensome and expensive for the petitioner, and even though the Commissioner's chances of success may be marginal. However, here, the law is clear; the Commissioner was not pursuing this litigation to establish any significant principle of tax law. He knew that he had the burden of proving fraud by clear and convincing evidence, and he knew that the litigation would be burdensome and expensive for the petitioner. He should have considered these circumstances in deciding whether to pursue the litigation; it is not enough that he had a doubt about the trustworthiness of some of the petitioner's documents; he should not have pursued the litigation unless he was convinced that he had a reasonable basis for believing that he could prove fraud by clear and convincing evidence.

The Commissioner, through his special agent, maintains that the general ledger was not produced pursuant to the summons; but on the record before us, we are convinced that it was in Mr. Weinberger's possession at the time of his meeting with the special agent and that it was made available to the special agent. Moreover, after Mr. Weinberger presented to the Justice Department pages allegedly taken from the general ledger, the Commissioner, if he did not accept the evidence, had the responsibility of making a further investigation to ascertain whether those pages were authentic; it is not enough for him to say merely that he suspected the authenticity of such pages. The petitioner was willing to cooperate in a further investigation, and even if the general ledger had not been made available to the special agent earlier, he had the responsibility of taking up Mr. Weinberger's offer and visiting his office to examine the general ledger.

Likewise, we are not persuaded by the Commissioner's argument that he was unaware of the reclassification of the proceeds of the first GM sale until the time of the trial. The special agent admitted that the investigation was commenced as a result of a report by a confidential source, and several of the Commissioner's witnesses, who had worked for the company and had been fired, reported on statements made by Mr. Casey allegedly showing that he did not wish to report all of his taxable income. It appears to us that the special agent relied unduly on his confidential source and the statements by the former employees of the company. Such information may have warranted an investigation, but such information did not justify a superficial conclusion that income was omitted. The special agent should have analyzed the general ledger, should have sought to reconcile its information with the financial statements, and should have interviewed his own witnesses about such reconciliation—they knew of the reclassification. Had the special agent made such investigation, he would have learned that the proceeds of the first GM sale had been reported.

We remain of the view that there was a substantial doubt as to when the second GM sale was completed and reportable. The purchase order states in one paragraph that the sales price was to be based on the quotations preceding the sale, but in another paragraph, it states that the price was to be based upon quotations after the sale. The GM representative was firm in his statement that the price was to be based on the quotations preceding the sale. However, he then admitted that the price was computed by th accounting department, and the price computed by him a trial was far different than the price agreed upon by th parties to the sale. Such circumstances cast doubt on hi testimony that the sales price was to be based upo quotations preceding the sale. We need not decide when, i fact, the sale was completed; it is clear to us that there wa a substantial doubt, and under such circumstances, th Commissioner knew, or should have known, that he lacke the clear and convincing proof needed to establish that th omission of the proceeds of the sale was fraudulent.

Mr. Casey's treatment of the RAD account was irregula and perhaps negligent. Yet, we were persuaded by hi testimony that the account was established to withhold th information from his wife; nevertheless, he should hav disclosed the information to Mr. Furlow and the CPA whe the time came to prepare the tax return. However, th circumstances surrounding the establishment of that a count and the failure to reveal the information to th preparers of the tax return are certainly not sufficient t show fraud.

The Commissioner has not elaborated on his position tha the petitioner did not exhaust his administrative remedie The Commissioner admits that there was a hearing befor the Appeals Division and that Mr. Weinberger did appe at such hearing on behalf of the petitioner. Apparently, th Commissioner rests his claim on the argument that M Weinberger should have explained the reclassification of th proceeds of the first GM sale. In our judgment, th Commissioner's argument fails. Mr. Weinberger participate in that hearing, and he presented sufficient information an argument to convince the Appeals officer of the merits his case. Under such circumstances, the Commissione cannot later argue that the petitioner did not exhaust h administrative remedies.

Finally, when we weigh the weakness of the Commissio er's case and the fact that the litigation might have bee avoided if he had conducted the indicated investigatio against the burden imposed upon the petitioner by th Commissioner's pursuing this litigation, we conclude th the Commissioner should not have (and it was unreasonab for him to have) pursued the litigation. Since he chose to do so, we believe that he should bear the petitioner's costs of litigation, and we so hold.

The petitioner's motion for costs will be granted and decision will be entered for the petitioner.

Reviewed by the Court.

Sterrett, Goffe, Chabot, Nims, Parker, Whitaker, Körner, Shields, Hamblen, Cohen, Clapp, Swift, Jacobs, Gerber, Wright, Parr, and Williams, *JJ.*, agree with this opinion.

Wells, *J.* did not participate in the consideration of this case.

Armco, Inc. Formerly Armco Steel Corporation and Subsidiaries, Petitioner *v.* Commissioner of Internal Revenue, Respondent

Armco, Inc. and Subsidiaries, Formerly Armco Steel Corporation and Subsidiaries, Petitioner *v.* Commissioner of Internal Revenue, Respondent

Docket Nos. 20037-85, 45229-85. Filed October 28,1986.

P sought a pretrial ruling on the admissibility of an affidavit of a former Treasury Department and Internal Revenue Service employee, now deceased, who assisted in drafting sec. 1.167(a)-11(d)(2), Income Tax Regs., to explain the intended meaning of the regulation. The affidavit was prepared in 1983, 12 years after the regulation was adopted. *Held*: The affidavit is irrelevant and therefore inadmissible under rule 401, Federal Rules of Evidence, because the affidavit expresses only an individual opinion and is not a statement of institutional intent, and was not contemporaneous with the promulgation of the regulation. Such views are an interpretation of the law and are not relevant evidence.

James P. Holden, *Kenneth I. Jonson* and *Joseph P. Esposito*, for the petitioner.

Joseph R. Goeke, for the respondent.

OPINION

WILLIAMS, *Judge*: Petitioner seeks a ruling prior to tri on the admissibility of an affidavit of a former employee o the Department of Treasury and the Internal Revenu Service who assisted in drafting section 1.167(a)-11(d)(2 Income Tax Regs. The proper application of this section o the regulations, particularly example (2) of section 1.167(a 11(d)(2)(vi), Income Tax Regs., is one of the issues that th Court must decide after trial. Respondent objects to th admission of the affidavit, and the parties have file memoranda in support of their respective positions.

On January 5, 1983, petitioner obtained the affidavit o Karl Ruhe purporting to explain the intent of the drafter in choosing the language and examples of section 1.167(a 11(d)(2), Income Tax Regs. Ruhe was Chief of the Enginee ing Appraisal Section, Office of Assistant Commissione (Technical), Internal Revenue Service, from 1962 to 197 From 1972 to 1980, he was Director of the Department o Industrial Economics, Department of Treasury. Ruhe als served as the principal technical adviser on depreciatio repair, and maintenance practices for the Internal Revenu Service. Ruhe was a member of a special task force o Internal Revenue Service and Treasury Department officia charged with formulating regulations interpreting sectio 167.[1] According to Ruhe and the affidavit of Ernest S Christian, Esq., then a staff attorney with the Office of Ta Legislative Counsel and a member of the Task Force, Ruh was principally responsible for originating the concept o the percentage repair allowance and for drafting the impl menting regulations, including example (2) of sectio 1.167(a)-11(d)(2)(vi), Income Tax Regs. Section 1.167(a 11(d)(2), Income Tax Regs., was adopted on June 22, 197 See T.D. 7128, 1971-2 C.B. 132. Ruhe is now deceased.

Petitioner asks the Court to admit the affidavit in lieu o Ruhe's testimony to support its interpretation of regul tions section 1.167(a)-11(d)(2). Respondent objects to th admission of the affidavit on grounds of both relevancy an hearsay. Petitioner contends that the affidavit of the perso principally responsible for conceiving the repair allowan and for drafting the regulation implementing the rule to be construed by the Court is manifestly relevant. Petitioner concedes that the affidavit is hearsay but contends that it falls within the "catch-all" exception to the hearsay rule, rule 804(b)(5), Federal Rules of Evidence.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in eff during the years in issue.

Rule 401, Federal Rules of Evidence, applicable in this Court pursuant to Rule 143, Tax Court Rules of Practice and Procedure, and section 7453, defines relevant evidence as "evidence having any tendency to make the existence of any *fact* that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." (Emphasis added.) The Ruhe affidavit addresses not the facts of this case but a legal issue in this case, specifically the proper interpretation of Example (2), section 1.167(a)-11(d)(2)(vi), Income Tax Regs. Because the affidavit does not tend to prove or disprove 'the existence of any fact that is of consequence' to the disposition of this case, it is not relevant within the meaning of rule 401.

First, Ruhe was only one member of a special task force charged with drafting the regulation at issue. His role was to provide the necessary factual background on depreciation, repair and maintenance practices in various industries. Even though in conceiving the repair allowance rule and in drafting example (2) he participated in developing the Treasury's policy, his opinion on the intended meaning of the example would be only one among a number of opinions held by individuals responsible for the adoption of the regulation. Presumably, the then Chief Counsel, the then Commissioner, the then Assistant Secretary (Tax Policy) and others also have views on the proper meaning of the regulation.

Second, no one's personal views can be accepted as a pronouncement of the intended meaning of the regulation. Ruhe's affidavit is not an expression of institutional views but of his personal views. We do not doubt that Ruhe was principally responsible for developing the rules and worked closely with Christian in drafting the implementing language of the regulation. Nevertheless, Ruhe's statement of *his* intent is not necessarily congruent with *institutional* intent. His affidavit is not, as petitioner argues, analogous to the memorandum from the Commissioner to the Secretary of Treasury discussed by the Supreme Court in *Jewett v. Commissioner*, 455 U.S. 305, 313-314 n. 15 (1982). Such a memorandum is a statement of the official views of the Internal Revenue Service in urging the adoption of the regulation by the Secretary. Such a memorandum is intended to state institutional views.

Third, even if Ruhe's affidavit could be shown to state fully, completely and accurately an institutional view of the intended meaning of the regulation, the statement was not contemporaneous with the promulgation of the regulation but was made 12 years later. Such a statement could, at best, have no more authority than a revenue ruling which states the institutional litigating position of the Internal Revenue Service. Cf. *Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146-1147 (5th Cir. 1971); *Estate of Lang v. Commissioner*, 64 T.C. 404, 406-407 (1975), affd. 613 F.2d 770 (9th Cir. 1980). The proper interpretation of a regulation as a matter of law is a responsibility that ultimately rests with the courts. In exercising its judicial function, the court may be aided by the views of the drafters on the intended meaning of the language, but to be accorded any weight, those views cannot be post hoc, especially 12 years after publication. In contrast, the Commissioner's memorandum in *Jewett* was contemporaneous with the transmittal of the regulations to the Secretary.

Finally, Ruhe's affidavit was not prepared for guidance to the public in interpreting the regulation. See *Deluxe Check Printers, Inc. v. United States*, 5 Cl. Ct. 498 (1984). Documents prepared for public consumption, such as a preamble that accompanies the publication of the regulations, are reviewed by the same drafters and policy reviewers who pass on the regulation itself. That review is undertaken with the knowledge that affected taxpayers will use such a document in attempting to understand and apply the regulation. A preamble will frequently express the intended effect of some part of a regulation. As a statement of intent that represents an institutional viewpoint, such a document might be helpful in interpreting an ambiguity in a regulation. An affidavit, such as Ruhe's however, cannot receive the care or scrutiny that a statement intended for public guidance receives.

We conclude, therefore, that a post hoc statement of an individual who assisted in the drafting or passed on the regulations is not evidence which tends to prove or disprove the facts at issue. Such views are an interpretation of the law and are not relevant evidence. The Ruhe affidavit is irrelevant and inadmissible.

Because we conclude that the Ruhe affidavit is inadmissible on relevancy grounds, we do not reach the issue of hearsay.

An appropriate order will be entered.

JON R. POLLEI AND CAROL J. POLLEI, PETITIONERS
v. COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

HARRY W. PATRICK AND RENEE L. PATRICK, PETITIONERS
v. COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

Docket Nos. 28737-84, 28738-84. Filed October 28, 1986.

Ps are police captains who receive a car allowance to operate specially equipped, personally owned vehicles in the performance as employees. Ps have deducted expenses of operation "against" the allowance. R has only questioned the portion of the deductions which are attributable to travel between police headquarters and Ps' homes. Ps have attempted to distinquish their case from others where we have found travel to be commuting by pointing out the requirement to be in contact with headquarters by radios. R contends that Ps must be in radio contact during any use of the specially equipped vehicle whether business or personal. *Held*, the portion of Ps' travel between headquarters and house is nondeductible commuting even though Ps may have to call in and respond to their radios during their travel.

Steven D. Woodland, for the petitioners.

Ronald J. Gardner, for the respondent.

GERBER, *Judge*: Respondent determined 1981 Federal income tax deficiencies of $537.30 for petitioners Pollei and $442 for petitioners Patrick and their cases have been consolidated for purposes of trial, briefing, and opinion. The sole issue for our consideration is whether police officers are entitled to deduct the cost of operating an unmarked police department equipped vehicle between their residence and police headquarters.

FINDINGS OF FACT

All petitioners resided in Salt Lake City, Utah, at the time each of the petitions was filed. Petitioners Jon R. Pollei (Pollei) and Harry W. Patrick (Patrick) were employed, during 1981, as captains in the Salt Lake City Police Department (SLCPD). During 1981, Pollei and Patrick commanded the detective and community affairs divisions, respectively. Police departments generally provide command officers (including captains) with police vehicles to assist in the performance of their duties. Prior to 1980, SLCPD supplied Pollei and Patrick with city-owned unmarked vehicles for their full-time use.

Pursuant to a Salt Lake City mayor's September 23, 1980, executive order to reduce costs, SLCPD Chief Willoughby issued an order, dated September 29, 1980, requiring command level officers to provide their own transportation.[1] Beginning October 1, 1980, each command level officer was to be placed on a car allowance program under which they would receive $250 per month. Under the program, SLCPD provided and installed the necessary paraphernalia to equip the privately owned vehicle for use as an unmarked police car. The conversion from city-owned to privately owned vehicles was an attempt to reduce police department operating costs. Chief Willoughby's order also contained an additional measure purporting to extend captains' (and other command officers') "tours of duty" from the time they report in and out by 2-way radio or telephone, rather than their actual arrival time at headquar ters.[2] Their responsibilities and activity during travel to and from headquarters did not change when they converted from city-owned to privately owned vehicles. Because the police officers did not receive additional remuneration, Chief Willoughby theorized that the city received more hours of police protection for the same cost.

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[1] It is unclear whether the order required petitioners to supply their own transportation t and from work only or for all purposes. Apparently, the SLCPD would have provided city-owned vehicle during their 8-hour work day, but not to be taken home or used durin off-duty hours.

In addition to calling in, each command officer possessed a paging device and could be reached at any time within the Salt Lake City area. Pollei and Patrick were required to call in at any time (whether on or off duty) they used the unmarked, specially equipped vehicle. Command officers were not compensated for the time consumed traveling between their residences and headquarters at the beginning and end of each work day. Pollei and Patrick's compensated work day began at 8 a.m., at which time they were to arrive at headquarters for their 8-hour shifts. All command officers were subject to off-duty call-in.[3] Pollei and Patrick each averaged 4 to 6 responses per month to radio messages while en route to and from headquarters. Examples of their responses included breaking up a fight and backing up another officer.

Petitioners claimed deductions and credits in connection with the privately owned vehicles used for police activity. Respondent disallowed only the portion that related to operation of the vehicle between headquarters and petitioners' residences each day.[4]

OPINION

This case adds yet another factual pattern to an already abundant melange of "commuting cases." Petitioners are police captains and were placed in "tour of duty" status during their daily round trip between their residences and police headquarters. This travel was accomplished in a specially equipped, privately owned unmarked vehicle sanctioned by the police department. Respondent argues that petitioners' daily round-trip travel between their residences and headquarters is a nondeductible personal commuting expense. Secs. 162, 262.[5] Petitioners contend that their situation varies from the usual commuting case because it involves "a police officer who went on duty at the time he entered the police car and who provided police services during the time he was traveling." The parties' position presents the wholly factual question of whether petitioners were commuting under the circumstances of this case.

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[2] The "on-duty call requirement" served a dual purpose. It was intended to place the officers in an earlier duty status providing additional patrol time and it placed privately owned vehicles under provisions of the city's self-insurance liability coverage. Apparently, the city was not liable unless the event occurred during the officer's "tour of duty."

[3] Apparently, petitioners' official obligations were no greater when traveling to and from their residences and headquarters than traveling in pursuit of purely personal objectives, such as grocery shopping, sports events, etc. As a police officer, there is an unwritten commitment to provide public assistance whether it occurs on or off duty.

[4] A $500 mathematical error Patrick made on his 1981 income tax return is not in dispute.

It is well established that expenses incurred in commuting from home to work are personal and not deductible. *Commissioner v. Flowers*, 326 U.S. 465 (1946); *United States v. Tauferner*, 407 F.2d 243 (10th Cir. 1969); secs. 162, 262; secs. 1.162-2(e), 1.212-1(f), 1.262-1(b)(5), Income Tax Regs. In order to be deductible, the travel "must be incurred in pursuit of business" and "necessary or appropriate to the * * * pursuit of business." *Commissioner v. Flowers, supra* at 467. Certain types of business-related travel have been found to be deductible: Travel while away from home, *Gilberg v. Commissioner*, 55 T.C. 611, 614 (1971); local travel incurred while performing a job, *Lopkoff v. Commissioner*, T.C. Memo. 1982-701; travel between jobs or job locations, *Fausner v. Commissioner*, 55 T.C. 620 (1971); travel between job locations where the principal place of business is located in the home, *Wisconsin Psychiatric Services, Ltd. v. Commissioner*, 76 T.C. 839 (1981); and possibly for an allocable portion of travel attributable to the transportation of job-required tools, *Fausner v. Commissioner*, 413 U.S. 838, 839 (1973).[6]

Petitioners' presentation is colorable and on the surface persuasive. They argue that the travel was necessary and in the performance of their jobs.[7] We must, however, find for respondent. We find that petitioners were not engaged in their jobs (business activity) during the time they traveled to and from headquarters. Petitioners admit that no previous case supports their position. They have attempted to distinguish several cases where police officers were denied travel expense deductions. *McCabe v. Commissioner*, 688 F.2d 102 (2d Cir. 1982), affg. 76 T.C. 876 (1981); *Chapman v. Commissioner*, T.C. Memo. 1982-68; *Bradley v. Commissioner*, T.C. Memo. 1973-163; *Marzano v. Commissioner*, T.C. Memo. 1970-159; *Fiore v. Commissioner*, T.C. Memo. 1968-104. Petitioners argue that their situation differs from these cases because petitioners' travel occurred within their "tour of duty," whereas the other officers' travel was outside their tours of duty. The police department's designation of petitioners' tour of duty as including commuting does not convert its status to that of a deductible business or job related expense. Petitioners, as supervisory police officers, were involved in "patrol" activity incidental to their primary responsibility. Petitioners' "patrol" responsibilities were no greater when in transit to headquarters from their homes than when they were involved in purely personal pursuits, such as going to a movie. Commuting is essential to most employees' employment, but is not a deductible expense. Commuting is one of the expenses that is so inherently personal that it cannot qualify for deductibility, irrespective of its role in the taxpayer's trade or business. *Moss v. Commissioner*, 80 T.C. 1073, 1080 (1983), affd. 758 F.2d 211 (7th Cir. 1985); *Fred W. Amend Co. v. Commissioner*, 55 T.C. 320, 325, 326 (1970), affd. 454 F.2d 399 (7th Cir. 1971); *Bakewell v. Commissioner*, 23 T.C. 803, 805 (1955).

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[5] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

[6] Petitioners' only position is that their travel between home and police headquarters was in performance of their jobs. No argument has been presented with respect to any of the other deductible categories of travel such as between jobs or while away from home.

[7] We are mindful of the importance of police services and the dedication and commitment of police personnel. Our charge, however, is to interpret the effect upon petitioners' income tax liability, which does not necessarily comport with local practices or reflect upon the quality or characterization otherwise attributed to a particular activity.

Petitioners did not argue or prove that they incurred additional expense in driving to and from headquarters and their residences due to the requirement to call in or begin their "tour of duty."[8] They simply argue that the travel time had been designated by the department as occurring during their "tour of duty."

Petitioners direct our attention to 1984 legislation and a temporary regulation concerning fringe benefits. Section 132, enacted as part of the Deficit Reduction Act of 1984,

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[8] Petitioners' allowance was a flat $250 monthly. It is conceivable that some of the allowance may have reimbursed purely personal travel.

Pub. L. 98-369, 98 Stat. 494, 665, excludes certain fringe benefits from gross income. Temporary Income Tax Regs. section 1.132-5T(h), 50 Fed. Reg. 52304 (Dec. 23, 1985), excludes from gross income the value of the use of an unmarked law enforcement vehicle. Section 132 and Temporary Income Tax Regs. section 1.132-5T are effective only for taxable years after the calendar year 1984. Petitioners' attempted analogy falls short for another reason. The excludability of a fringe benefit does not conversely reflect that the activity giving rise to the benefit would have been deductible if expended rather than received by the recipient. Indeed, the purpose or need to exclude "fringe benefits" from gross income is usually attributable to the fact that the recipient would not otherwise be entitled to an offsetting deduction.

To reflect the foregoing,

Decisions will be entered for the respondent.

TRANSPAC DRILLING VENTURE 1982-22, PRITPAL S. PURI, JOSEPH BOLOGNA, SEYMOUR M. SLATER, LEON PEARCE, EDWARD EDELMAN, RAMKUMAR AGRAWAL, PHILIP PEARLSTEIN, CHRISTOPHER F. KENDALL, AND MELBA L. HARVEY, JR., PARTNERS OTHER THAN THE TAX MATTERS PARTNER, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 29180-86. Filed October 28, 1986.

Ps are notice partners of a partnership subject to the partnership audit and litigation provisions. R issued a notice of final partnership administrative adjustment on Apr. 14, 1986. The 90th day of the period for the tax matters partner to file a petition for readjustment fell on July 13, 1986, a Sunday. The tax matters partner has not filed a petition. Ps filed an identical petition in this case on July 15, 1986, and in docket No. 28322-86 on July 14, 1986. R has moved to dismiss the petition in this case as a duplicate petition. *Held*, the 90-day period of sec. 6226(a), I.R.C. 1954, for filing a petition by the tax matters partner did not close until close of business July 14, 1986. *Held, further*, the petition in this case was not a duplicate petition but was the petition that commenced the partnership action.

Michael I. Saltzman, for the petitioners.
Robert J. Percy, for the respondent.

OPINION

WILLIAMS, *Judge*: This case is before the Court on respondent's motion to dismiss duplicate petition pursuant to Rule 53, Tax Court Rules of Practice and Procedure.

The Commissioner determined adjustments to the Federal partnership return of Transpac Drilling Venture 1982-22 as set forth in his notice of final partnership administrative adjustment issued on April 14, 1986. The issue this Court must decide is whether the petition for readjustment of partnership items, filed by the notice partners in this case pursuant to section 6226(b),[1] was effective to commence a partnership action.

Respondent sent to the tax matters partner and to the notice partners of Transpac Drilling Venture 1982-22, including all petitioners herein, the notice of final partnership administrative adjustment on April 14, 1986. No petition for readjustment of partnership items has been filed by the tax matters partner.

Petitioners, who are notice partners within the meaning of section 6231(a)(8), filed a petition for readjustment of partnership items of Transpac Drilling Venture 1982-22 on July 14, 1986, docket No. 28322-86. Petitioners also filed a petition in this case, identical to that in docket No. 28322-86, on July 15, 1986.

Respondent argues that the petition in docket No. 28322-86 was proper pursuant to section 6226(b), and that therefore the petition in this case must be dismissed as a duplicate of the petition in docket No. 28322-86. We disagree.

Section 6226 provides in relevant part:

> (a) PETITION BY TAX MATTERS PARTNER.—Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—
>
> (1) the Tax Court,
>
> * * *
>
> (b) PETITION BY PARTNER OTHER THAN TAX MATTERS PARTNER.—

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, unless otherwise indicated.

> (1) IN GENERAL.—If the tax matters partner does not file a readjustment petition unde subsection (a) with respect to any final partnership administrative adjustment, any notic partner (and any 5-percent group) may, within 60 days *after the close of the 90-day period set forth in subsection (a)*, file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a). * * * [Emphasis added.]

The notice of final partnership administrative adjustment for Transpac Drilling Venture 1982-22 was mailed on April 14, 1986. Pursuant to section 6226(a), the tax matters partner had 90 days from that date to file a petition for readjustment of partnership items. The last of the 90 days was July 13, 1986, a Sunday. Consequently, the 90-day period of section 6226(a) did not close until the close of business, Monday, July 14, 1986. Sec. 7503.

Section 6226(b) permits partners other than the tax matters partner to file a petition for readjustment of partnership items only after the "close of the 90-day period" in which the tax matters partner may file such petition. Sec. 6226(b); see H. Rept. 97-760, at 603 (Conf. 1982), 1982-2 C.B. 600, 665. Since the 90-day period of section 6226(a) included July 14, 1986, the petition filed by the notice partners on July 14, 1986, docket No. 28322-86, was ineffective to commence a partnership action. See Rule 240(c)(1)(ii), Tax Court Rules of Practice and Procedure. Therefore, the petition in this case, filed on July 15, 1986, was not a duplicate petition but was the petition which commenced the partnership action of Transpac Drilling Venture 1982-22.

Accordingly,

An appropriate order will be issued.

JAMES O. TOMERLIN TRUST, TRANSFEREE, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16219-85. Filed October 29, 1986.

R determined deficiencies of personal holding company tax against P, a transferee of T, based upon his determination that certain payments received by T from X under a contract involving the right to use a trademark constituted royalties from a license rather than proceeds from the sale of an asset. Under the facts, *held*, that the contract between T and X was

a sale, not a license, and the moneys received by T, although ordinary income, were not royalties. *Held, further,* that T was not a personal holding company. Sec. 1253(a), (b), and (c), I.R.C. 1954, interpreted.

Roland K. Martin, Jr., for the petitioner.
Kenneth A. Burns, for the respondent.

KÖRNER, *Judge*: By statutory notice of deficiency dated March 26, 1985, respondent determined that petitioner was liable, as transferee, for the following deficiencies of personal holding company tax of Cyclo Automotive, Inc., for the years and in the amounts as follows:

Years	*Deficiency in personal holding company tax*
1979	$37,625
1980	1,394
1981	24,262
1982	[1] 29,895

The ultimate issue presented involves the liability of Cyclo Automotive, Inc., for personal holding tax under section 541.[2] To resolve this ultimate issue, we must decide whether certain payments made in the years in question to Cyclo Automotive, Inc., constitute income from the sale of an asset under section 1253, or royalty income within the meaning of section 543.

FINDINGS OF FACT

Petitioner is a trust with its principal place of business at Gardnerville, Nevada. Petitioner is the transferee of assets of Cyclo Automotive, Inc. (Automotive), a dissolved Nevada corporation. Automotive's income tax returns for the years 1979 through 1983 were filed with respondent's Ogden Service Center.

William R. Tomerlin and James O. Tomerlin purchased the stock of Automotive in approximately 1971. For the years 1979 through 1982 inclusive, the shareholders of

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[1] Respondent now concedes that, because of a computational error, the correct amount for this year should be $21,353.

[2] All statutory references are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

Automotive were William R. Tomerlin, who owned 50 percent of the stock, and James O. Tomerlin or his testamentary trust, which owned the other 50 percent of the stock. Automotive was an automobile chemical company selling various automotive products, such as carburetor cleaner, penetrating oil, white grease and various other lubricating and cleaning products. Certain of these products were covered by the registered trademark "CYCLO," which was owned by Automotive.

Accra-Pac, Inc. (Accra-Pac), was an Indiana corporation, apparently owned by parties unrelated to the Tomerlins. On February 3, 1976, a contract was entered into between William R. Tomerlin and James O. Tomerlin, as shareholders of Automotive; Automotive (described as licensor); and Accra-Pac (described as licensee). The contract first recited that Licensor was the owner of the trademark "CYCLO" which was a "strong mark in connection with the sale and distribution of oil lubricants for automobiles and other vehicles", and that "the parties desire to agree to the exclusive license and use by Licensee of the Trademark in producing, selling and distributing these products in the United States and throughout the world."

After these recitals, the operative provisions of the contract, as relevant and material herein, were as follows:

> A. LICENSE. Licensor grants to the Licensee the exclusive right to use, and the Licensee undertakes to use, the trademark CYCLO in the United States and throughout the world, in connection with those products known to the parties and listed in Exhibit "A", attached hereto and made a part of this Agreement and for all new products that may be developed by Licensee during this Agreement.[3]
>
> B. QUALITY OF GOODS. The Licensee shall manufacture, distribute and sell the products listed in Exhibit "A" and any new products according to the same standards of quality existing concerning such products. Licensor, however, shall have the right to inspect the operation of Licensee in order to insure the application of satisfactory quality control and the maintenance of same throughout the term of this Agreement.
>
> C. EXCLUSIVE USE OF TRADEMARK.
>
> A. Licensor agrees that Licensee's right to use the Trademark shall be sole and exclusive; and that no other persons or parties have any right or license to the use of the Trademark, or will be given any such right or

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[3] Exhibit "A" attached to the contract listed certain products then manufactured and sold by Automotive under the trade name "CYCLO."

license during this Agreement. Licensor agrees that it will take all necessary and appropriate action to protect this Trademark against infringement or any other unlawful use and will, at all times, take all action necessary to keep the Trademark strong.

B. Licensor agrees that it will not, during this Agreement, carry on any business activity in which the Trademark is used, or carry on or engage in any business involving the Products covered by this Agreement.

D. With respect to terms of payment, the contract provided that licensee should pay to licensor as follows:

(1) With respect to the CYCLO products covered by Exhibit "A," the sum of 9 cents per can for the first 1 million cans produced by licensee each year, and thereafter at the rate of 4 cents per can of product. On an annual basis, such payments were to be scaled upwards or downwards depending upon changes in the Bureau of Labor Statistics Cost of Living Index.

(2) With respect to new products developed and sold by Accra-Pac under the CYCLO label, the same schedule of payments was to apply, except that no payments would be due with respect to new products for the first year of production thereof.

(3) Payments were to be made by licensee to licensor on a monthly basis.

E. It was agreed that the contract would continue and renew itself automatically from year to year, so long as licensee had paid to licensor at least $40,000 biannually in productivity payments in any year. The licensee was to make an accounting of its sales periodically to licensor, and licensor had the right to inspect books of licensee with regard to production of product covered by the CYCLO trademark. The contract was terminable only:

(1) Upon 60 days written notice from licensee to licensor prior to the end of each 6-month period; or

(2) Upon failure of the licensee to make the payments provided for in the contract.

F. Licensee acknowledged the ownership of the trademark by licensor. However, if and when the point arrived when licensee had paid licensor contingent production payments equal to $1 million, then at that time licensor was obligated to transfer all right, title and interest in the trademark to licensee. In such event, licensee was to continue to make productivity payments to licensor for the indefinite future upon a certain stated basis. Prior to the payment of $1 million by licensee to licensor (and the consequent transfer of title to the trademark to licensee), the contract provided that the licensee "will not sell the CYCLO business independently or separate from an overall sale of Accra-Pac, Inc. Should it be determined that licensee be desirous of assigning the CYCLO business then same shall not be done without prior approval of licensor but said approval shall not be unreasonably withheld."

The above agreement was in effect between Automotive and Accra-Pac throughout the period in question, and, under the terms of this agreement, Automotive received and reported the following income:

Year	*Payments from Accra-Pac*	*Other income*
1979	$118,510	$917
1980	128,866	183
1981	115,098	132
1982	121,732	13,317

At the time of the liquidation and dissolution of Automotive in December 1982, title to the trademark had not yet been transferred to Accra-Pac, and the above contract was distributed by Automotive to its shareholders in liquidation. Petitioner thus received assets in liquidation of Automotive in an amount at least equal to the total deficiencies, as corrected, as determined by respondent against Automotive.

OPINION

The instant case involves a dispute as to the liability of petitioner's transferor, Automotive, for the personal holding company tax under sections 541, et seq. With respect to Automotive, there is no dispute between the parties that the stock ownership requirements of section 542(a)(2) are met. Nor does there appear to be any dispute that Automotive qualifies as a personal holding company under the income requirements of section 542(a)(1), if it is determined that the payments here in question constitute royalty income, as opposed to income from the sale of an asset, nor that, in such event, respondent's computation of personal holding company tax liability is correct.[4] Petitioner likewise concedes that all the payments in question, even if considered to be the proceeds of sale, are to be treated as ordinary income under the provisions of section 1253. Finally, petitioner concedes that it is a transferee of the assets of Automotive, within the meaning of section 6901, to the full extent of the liability of Automotive as determined by respondent herein, if such liability is found to exist.

Thus, the only issue which we must resolve is whether the payments made by Accra-Pac to Automotive in the years in issue, pursuant to the contract between them of February 3, 1976, constituted royalty payments under a licensing agreement of a trademark, or constituted payments pursuant to a contract of sale of an asset.

Respondent, relying upon the provisions of section 1253, as well as the contract itself, argues that, as a matter of fact as well as law, the contract between Automotive and Accra-Pac was nothing more than a license by the former to the latter to use and exploit a trademark which Automotive owned; that Automotive retained title to the trademark for an indefinite period; and that Automotive retained such substantial rights and interests in the trademark under the terms of the contract that no sale of the trademark resulted, with the further result that the payments by Accra-Pac to Automotive under the contract must be held to be royalties within the meaning of section 543(a)(1).

Petitioner, on the other hand, citing a number of cases decided prior to the enactment of section 1253 (and some involving patents rather than trademarks), urges us to find and hold that the contract herein, correctly construed, was not a license but rather involved the sale of the entire business of Automotive to Accra-Pac. As such, petitioner urges, the payments made by Accra-Pac to Automotive should be considered as the proceeds of a sale of assets, rather than as royalty income from a license, even though, concededly, such payments are to be treated as ordinary income in the hands of Automotive because of the specific provisions of section 1253.

In support of this line of argument, petitioner reminds us that it has been held that the name given to an agreement is not conclusive as to the substance of the transaction, citing *Waterman v. Mackenzie*, 138 U.S. 252 (1891); *Hickman v. Commissioner*, 29 T.C. 864, 872 (1958); *Kimble Glass Co. v. Commissioner*, 9 T.C. 183, 189 (1947). Even where the agreement is called a license (as here) and the parties are referred to as "licensor" and "licensee," the terms are not determinative. If it appears from the agreement and the surrounding circumstances that the parties intended a transfer of all rights in and to an asset, such intention will be given effect, regardless of the words used. *Bell Intercontinental Corp. v. United States*, 180 Ct. Cl. 1071, 381 F.2d 1004 (1967); *Puschelberg v. United States*, 330 F.2d 56 (6th Cir. 1964); *Reid v. Commissioner*, 26 T.C. 622, 632 (1956). The earlier cases have also held, however, that where less than all rights to an asset are transferred, there may only be a license, not a sale. *Walen v. United States*, 273 F.2d 599 (1st Cir. 1959); *Kimble Glass Co. v. Commissioner*, *supra*.

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[4] See note 1 *supra*.

Petitioner points particularly to the case of *Kavanagh v. Evans*, 188 F.2d 234 (6th Cir. 1951), in which it was held that where there was a full "license" of all rights to manufacture, use, and sell products covered by a patent for the full life of the patent, there was in fact a sale of the patent. Even though title to the patent was not to be transferred until certain payments were made, the "licensee" became the equitable owner of the patent rights covered by the agreement. Further, petitioner points to the prior holding that the fact that a grantor of a license can terminate the agreement under certain conditions does not negate the fact of a sale; such rights are viewed as conditions subsequent in the event of a default in performance under the contract. *Bell Intercontinental Corp. v. United States*, *supra*.

We do not disagree with the general propositions, urged by petitioner, that the nomenclature or labels which the parties use in a contract are not necessarily determinative of its true nature, which is to be ascertained from the entire content and thrust of the contract provisions. Nor do we disagree with the general proposition, enunciated in the cited earlier cases, that a contract which transfers all substantial rights to an asset from the grantor to grantee, reserving no significant rights or interests in the grantor, may be held to be the sale of an asset rather than a mere license thereof, in spite of the terms used. The problem remains, however, to determine what constitutes such retained substantial rights or interest in a given case, so as to make the transaction a license rather than a sale. This problem brings us face to face with section 1253.

By 1969, there had apparently arisen some confusion and uncertainty in the law with respect to sales vs. licenses of trademarks and franchises. Congress addressed these concerns in the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487, and in section 516(c)(1) of that act, Congress added section 1253 to the Code as an attempted legislative solution to the problem.

The legislative history is instructive. In the Senate Finance Committee report on the pending bill, and as a background for the enactment of the new section 1253 of the Code, the Committee said, in relevant part:

> Present law.—Questions have arisen under present law concerning the proper tax treatment of the transferor and the transferee of a franchise. A similar situation exists in the case of tranfers of trademarks and trade names.
>
> It is difficult to resolve under present law whether the transfer of a franchise, trademark, or trade name is to be treated as a sale or as a license, and whether the transferors are selling franchises, trademarks, and trade names in the ordinary course of business. Depending upon how these questions are resolved, the transferor will receive ordinary income or capital gains treatment on the gain he realizes on the transfer. At present, these problems must be resolved under general tax principles, and this has produced differing results in the courts, despite factual similarities in the interest of the franchises, trademarks, or trade names transferred.
>
> For a transaction to receive capital gains treatment, property which is transferred must generally constitute a capital asset and must be sold or exchanged. It has been frequently necessary for the courts to determine whether a variety of conditions included in the agreement between the transferor and the transferee transform a purported sale into a license, thus requiring the gains from the transaction to be taxed as ordinary income.
>
> This question has resulted in a division of authority among the courts, some finding a sale and others a license. In either case, the decisions generally have been based on varying conditions in the transfer agreement and, when the agreement has been interpreted as reserving significant powers, rights, or continuing interests to the transferor, then it has been held that such reservations preclude a finding of a sale.
>
> * * * * * * *

General reasons for change.—Since present law does not specifi deal with the transfer of a franchise, trademark, or trade name, and there appears to be considerable diversity of opinion among courts whether such a transfer constitutes a license or a sale and whether or all of the sale constitutes the sale of a capital asset, the comm agrees with the House that Congress should clarify these prob through legislation with regard to franchises. In addition, the comm believes this should encompass trademarks and trade names and als treatment of transferees in these cases insofar as the deductibility o payments they make to transferors is concerned.

Some transferors retain significant powers, rights, or contin interests with respect to the subject matter of the franchise, tradem or trade name. The committee believes that if the transferor exer continuing, active, operational control of a franchise, trademark, or t name, by retaining significant powers, rights or continuing interests, this exercise of control is inconsistent with a sale or exchang property.

* * * * * * *

In many cases the question whether the transfer of a franc trademark, or trade name results in capital gain or ordinary incom the transferor could be resolved with reference to whether the prop was held primarily for sale in the ordinary course of business.

* * * * * * *

Explanation of provisions.— * * *

The committee amendments provide that the transfer of a franc trademark, or trade name is not to be treated as a sale or exchange capital asset if the transferor retains any significant power, righ continuing interest with respect to the subject matter of the franc trademark, or trade name. Thus, a transferor is not to receive ca gains treatment in these cases. If the transfer agreement incl significant conditions or restrictions which are subject to the transfe approval on a continuing basis, this power to exercise continuing, ac operational control over the transferee's business activities is t considered as a retention by the transferor of a significant power, r or continuing interest. Moreover, if the transferor's conduct constit participation in the commercial or economic activities of the transfe business, then this also is to be regarded as a retention of a signifi power, right, or continuing interest. These rules also were containe the House bill, but only with respect to franchises.

Under the committee amendments the concept of a "significant po right, or continuing interest" is to include, but is not to be limited to a right to disapprove any assignment or any part thereof; (B) a righ terminate at will; (C) a right to prescribe the standards of qualit products used or sold or of services furnished, and of the equipment facilities used to promote such products or services; (D) a right to re that the transferee sell or advertise only products or services of transferor; (E) a right to require that the transferee purchase sub tially all of his supplies and equipment from the transferor; (F) and a right to payments contingent on the productivity, use or disposition of the subject matter if such payments constitute a substantial element under the transfer agreement. The House bill in effect only included factors (A) and (B) above in the concept of a significant power, right, or continuing interest.

In addition, the committee amendments (but not the House bill) provide that all amounts received or accrued by the transferor on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name, which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred are to be treated as ordinary income. Contingent payments would include continuing payments (other than installment payments of a principal sum agreed upon in the transfer agreement) measured by a percentage of the selling price of products marketed or based on the units manufactured or sold, or any other similar method based upon production, sale or use, or disposition of the franchise, trademark, or trade name transferred.

[S. Rept. 91-552, at 207-210 (1969), 1969-3 C.B. 423, 554-556.]

The language of the Conference Committee report on the bill was not substantially different:

The Senate amendment makes more specific the rules of the House bill and extends these rules to trademarks, and trade names. A "franchise" includes "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." A "significant power, right, or continuing interest" includes, but is not limited to, a right to disapprove any assignment; a right to terminate at will; a right to disapprove any assignment; a right to require exclusive sale or advertising of products or services of the transferor; a right to require exclusive purchases of supplies and equipment from the transferor; and a right to payments contingent on productivity if such payments constitute a substantial element under the transfer agreement.

Under the Senate amendment, contingent payments are treated as ordinary income and are deductible by the transferee as trade or business expenses.

[Conf. Rept. 91-782 (1969), 1969-3 C.B. 644, 669.]

As enacted, and effective for transfers after December 31, 1969, section 1253 provides in relevant part as follows:

SEC. 1253. TRANSFERS OF FRANCHISES, TRADEMARKS, AND TRADE NAMES.

(a) GENERAL RULE.—A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

(b) DEFINITIONS.—For purposes of this section—

(1) FRANCHISE.—The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, o provide goods, services, or facilities, within a specified area.

(2) SIGNIFICANT POWER, RIGHT, OR CONTINUING INTEREST.—The term "significant power, right, or continuing interest" includes, but is no limited to, the following rights with respect to the interest transferred

(A) A right to disapprove any assignment of such interest, or any part thereof.

(B) A right to terminate at will.

(C) A right to prescribe the standards of quality of products use or sold, or of services furnished, and of the equipment and facilitie used to promote such products or services.

(D) A right to require that the transferee sell or advertise only products or services of the transferor.

(E) A right to require that the transferee purchase substantially a of his supplies and equipment from the transferor.

(F) A right to payments contingent on the productivity, use, o disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agree ment.

(3) TRANSFER.—The term "transfer" includes the renewal of franchise, trademark, or trade name.

(c) TREATMENT OF CONTINGENT PAYMENTS BY TRANSFEROR.—Amount received or accrued on account of a transfer, sale, or other disposition o a franchise, trademark, or trade name which are contingent on th productivity, use, or disposition of the franchise, trademark, or trad name transferred shall be treated as amounts received or accrued fro the sale or other disposition of property which is not a capital asset.

In the context of the controversy presented in the instan case—whether the contract in question represented a sale o a license of the trademark "CYCLO"—a close reading of th above quoted portions of section 1253 is revealing, both fo what the statute does as well as for what it does not do Thus, sections 1253(a) and 1253(b), read together, provid that if the transferor of a franchise, trademark, or trad name retains any of the significant powers, rights, o continuing interests specified in section 1253(b)(2), then any such transfer "shall not be treated as a sale or exchange o a capital asset." As a result, any payments received by th transferor under such contract will be treated as ordinary income in the hands of the the transferor.

What section 1253(a) does *not* say is that such a transfe shall not be treated as a sale at all. Thus, as to transfers o trademarks occurring after December 31, 1969, to which section 1253(a) applies, various possibilities exist: (a) Tha the transfer is a true sale of an asset which is a capital asset in the hands of the transferor, so that the proceeds therefrom qualify for capital gains treatment (subject however to the provisions of section 1253(c), discussed *infra*); (b) that the transfer is a true sale of a capital asset, but the proceeds therefrom are to be treated as ordinary income because the transferor has retained one or more of the significant powers detailed by section 1253(b)(2); (c) that the transfer is a true sale, but that the trademark constitutes an asset held for sale to customers in the ordinary course of business, and is therefore not a capital asset within the meaning of section 1222, with the result that the proceeds therefrom are to be treated as ordinary income; or (d) that the transfer is not a true sale at all, but is a mere license, so that the proceeds therefrom are to be treated as ordinary income.

Thus, although sections 1253(a) and 1253(b), read together, tend to bring some clarity to the confused condition of the law by enumerating specific instances when the proceeds of sale of a trademark, even though a capital asset in the transferor's hands, are to be given ordinary income treatment, section 1253 undertakes to provide no new clear standard to determine whether the transaction is a sale or a license, nor to determine whether the trademark is a capital asset or an asset held for sale to customers in the ordinary course of business.[5]

Section 1253(c), in turn, provides that even where a sale of a trademark, franchise, or trade name has taken place, and even if such sale is otherwise to be treated as the sale of a capital asset, nevertheless any sale proceeds which are made contingent upon the productivity, use, or disposition of the asset by the transferee shall be treated as ordinary income in the hands of the transferor. Thus, it is possible for a transfer of a trademark, otherwise qualifying as the sale of a capital asset, to receive capital gains treatment with respect to the proceeds of sale which are not contingent upon production or use, whereas those portions of the sales proceeds which *are* contingent upon production or use, even if not a "substantial element" under the transfer agreement (see sec. 1253(b)(2)(F)), are to be given ordinary income treatment.

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[5] See and compare sec. 1.871-11(c), Income Tax Regs.

In the case now before us, therefore, section 1253 does not provide the answer. The parties have already stipulated that all the proceeds of the transfer of the "CYCLO" trademark in this case are to be treated as ordinary income under section 1253. We cannot tell whether this stipulation is based upon the fact that Automotive retained a "right to productivity" payments under the contract which constituted a "substantial element under the transfer agreement," within the meaning of section 1253(a)(2)(F), or whether the parties were in agreement that all the payments to be received by Automotive under the contract constituted payments based upon production or use, within the meaning of section 1253(c). In either event, the result is the same, and therefore we do not need to resolve the point.

What remains, however, is the disputed question as to whether there was a sale at all of the trademark, or merely a license to use the same. On this troublesome question, section 1253 provides no answer, and we are told that this new section is not to be consulted as a guide to a codification of the rules in effect prior to its enactment. *Conde Nast Publications, Inc. v. United States*, 575 F.2d 400 (2d Cir. 1978); *Consolidated Foods Corp. v. United States*, 569 F.2d 436 (7th Cir. 1978). We are therefore remitted to the confusing and sometimes contradictory state of the law as it existed prior to the enactment of section 1253. As the Court of Appeals said in *Consolidated Foods Corp. v. United States*, 569 F.2d at 437:

> This issue of whether a transfer of the use of a trademark is a sale or a license for tax purposes is a thorny one, and has not always been consistently solved in the courts. The basic problem is to determine the extent to which the transferor retains proprietary rights in the transferred asset. If the transferor retains sufficient proprietary rights, the transfer must be considered a license rather than a sale. The relevant case law lacks clear standards as to how restrictive the agreement may be before it constitutes a license rather than a sale, and, indeed, reflects a splintering of authority among the several courts of appeals. * * *

In *Conde Nast Publications, Inc. v. United States*, *supra*, the Court of Appeals for the Second Circuit held that the terms of a 1961 transfer of a trademark and trade name constituted a sale rather than a license, since the transferor retained no significant rights or interests in the asset transferred, or control of the business in the hands of the transferee. The retention by the transferor of the right to inspect for quality control, and the right to terminate the agreement under certain circumstances, were held to be no more than legitimate steps to protect the value of the trademark which was to be the source of the payments to the transferor.

In the same year, however, and under somewhat similar facts, the Court of Appeals for the Seventh Circuit in *Consolidated Foods Corp. v. United States, supra*, concluded that the rights retained were sufficiently extensive so that the transaction should be considered a license rather than a sale.

In *Devine v. Commissioner*, 558 F.2d 807 (5th Cir. 1977), affg. T.C. Memo. 1975-251, this Court had held, after analyzing the various factors in the relevant contract, including the rights retained by the transferor, that (a) there had been a sale rather than a license, and (b) that the franchise which was sold was not a capital asset, so that payments received were to be treated as ordinary income. Noting that the issue of sale versus license had not been appealed by the Commissioner, the Court of Appeals affirmed the holding of the Tax Court that the payments in question were to be treated as ordinary income from the sale of an asset held for sale to customers in the ordinary course of business.[6]

Finally, in *Republic Automotive Parts, Inc. v. Commissioner*, 68 T.C. 822 (1977), affd. 611 F.2d 645 (6th Cir. 1979), this Court held that where the grantor gave the grantee in 1955 the right to use a trademark and trade name for only 15 years, also reserving the right to supervise quality control and to prevent the further assignment of the trademark without the grantor's consent, the transaction was to be treated as a license, not a sale. The holding of the case, however, appears to be based primarily upon the fact that the 15-year term of the contract was well short of the useful life of the trademark, so that the grantor was held to have retained substantial ownership rights in the asset after the expiration of the contract.

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[6] The Court of Appeals, noting that sec. 1253 did not apply to the transaction before it, which occurred prior to 1970, nevertheless opined in dictum that, if sec. 1253 *were* to be applied to the facts before it, the transfer "could not be construed as 'sales.'" *Devine v. Commissioner*, 558 F.2d 807, 813 n. 3 (5th Cir. 1977). However, as we have noted, sec. 1253 does not purport to lay down any new rule governing the determination of whether a sale or a license of a trademark actually takes place.

Further discussion of the numerous cases which have decided this issue one way or the other would not appear to be particularly helpful, and we conclude that we must therefore examine the contract provisions in the case before us, in order to determine whether Automotive retained such substantial rights and interests that it must be held that a license rather than a sale occurred.

Initially, we reject petitioner's contention, advanced at trial and on brief, that the contract in question here involved the sale of the entire business of Automotive rather than of the trademark "CYCLO." The contract provisions are clearly limited to the trademark, and to products manufactured and sold under that trademark—both the specific products enumerated in the contract, as well as new products that might be developed later by Accra-Pac. We find no ambiguity in the contract provisions with respect to the subject matter of the contract. It was a right, under the terms and conditions stated, to acquire, use and exploit the trademark "CYCLO," and it did not purport to encompass any other assets of automotive, including any other patents or trademarks which automotive might own, or any products not then covered by the "CYCLO" trademark. Whether Automotive owned any such assets at the time the instant contract was entered into in 1976 does not appear from this record, but it is clear to us that nothing further was intended.

Examining the contract provisions themselves, we conclude that what was intended here and what in fact happened was a sale rather than a license of the trademark. In reaching this conclusion, we find the following contract provisions controlling: (a) The grant of the trademark by Automotive to Accra-Pac was exclusive, worldwide, and forever, so long as Accra-Pac made the required production payments; (b) at such time as Accra-Pac had made production payments to Automotive of $1 million, Automotive was required to transfer legal title to the trademark to Accra-

Pac (as distinguished from a mere *option* in Accra-Pac to acquire such title); (c) Automotive had no right to terminate the agreement, except upon the failure of Accra-Pac to make the required periodic payments; furthermore, after the transfer of title to the trademark from Automotive to Accra-Pac, such termination rights no longer applied, even if Accra-Pac failed to make the required continuing payments; (d) although Accra-Pac was not permitted to dispose of the portion of the business using the trademark "CYCLO" separately from a sale of Accra-Pac's entire business, without Automotive's prior approval, "said approval shall not be unreasonably withheld." We regard this as nothing more than providing Automotive with reasonable security to insure that the trademark would not fall into the hands of those who would mismanage it and destroy its value; (e) Automotive retained the right to inspect the business operations of Accra-Pac to insure continuing quality control. Here again, however, we regard this as nothing more than a reasonable right which Automotive could retain to insure that the trademark, which was the asset intended to produce the production payments, would not be mismanaged so that its ability to produce income was destroyed (see *The Conde Nast Publications Inc. v. United States*, *supra*); and (f) finally, Automotive agreed that it would not use the trademark any further, nor engage in any business involving the products covered by the trademark which was conveyed to Accra-Pac.

We therefore hold that under the contract in question, Automotive parted with all its substantial rights, both present and future, in and to the trademark, reserving to itself only such limited rights as were reasonable and appropriate so that it could safeguard the integrity of the asset which was intended to produce the income for it. Even though the title to the patent was not to be transferred until a later date, and until a certain level of payments was reached, we hold that Accra-Pac became the equitable owner of the patent rights covered by the agreement upon execution of the contract on February 3, 1976. *Kavanagh v. Evans, supra*. See and compare *Bell Intercontinental Corp. v. United States, supra*; *Reid v. Commissioner, supra*.

Since we hold that the contract involved in this ca
resulted in a sale, rather than a license, the second aspect
the problem presented to us is resolved. For person
holding company purposes, the income derived from the sa
of the CYCLO trademark may be ordinary gross incom
within the meaning of section 543(b)(1), but, as income fro
the sale of an asset, it does not ipso facto constitu
royalties within the meaning of section 543(a)(1).[7] Since o
findings show that Automotive's adjusted ordinary gro
income in the years in question was not composed
personal holding company income to the extent of
percent or more, within the meaning of section 542(a)(
absent the payments here in question, it results th
Automotive was not a personal holding company liable f
the tax imposed by section 541 in the years before us.

Decision will be entered for the petition

JAMES W. SYMINGTON AND SYLVIA S. SYMINGTON, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 12523-83. Filed October 29, 1986.

Petitioners made a gift of an open-space easement to the Virginia Outdoors Foundation. *Held*, the value of the gift for purposes of a charitable deduction is determined on the basis of before-gift and after-gift valuations of the property subjected to the easement. *Held, further*, the approach to valuation cases set forth in *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 451 (1980), is reiterated.

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[7] Both parties cite and rely upon a portion of respondent's proposed regulations in t
regard. Proposed Treasury Reg. sec. 1.1253-1(b), 36 Fed. Reg. 13148 (July 15, 1971), provi
in relevant part:

"However, treatment of such amounts as ordinary income is not determinative as to whet
such amounts will be treated as royalty for purposes of any section of the Code specific
relating to royalties. Such determination shall be made pursuant to such section of the Cod

As we most recently said in *Driggs v. Commissioner*, 87 T.C. 759 (1986):

"Although our opinion does not conflict with the proposed regulations, we do not rely u
them as authority because they 'carry no more weight than a position advanced on brief
the respondent.'" *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970); *Mi*
v. Commissioner, 70 T.C. 448, 460 (1978). See also *Mearkle v. Commissioner*, 87 T.C.
(1986).

Reuben B. Robertson, Arthur K. Mason, and *Raymond J. Sherbill,* for the petitioners.

Ronald D. Pinsky, for the respondent.

OPINION

TANNENWALD, *Judge*: Respondent determined a deficiency of $24,547.47 in petitioners' Federal income tax for the taxable year ended December 31, 1979. After concessions, the sole issue for decision is what was the fair market value, on October 9, 1979, of an open-space easement which petitioners donated to the Virginia Outdoors Foundation. For reasons of convenience, we have combined our findings of fact and opinion.

Some of the facts have been stipulated and are so found. This reference incorporates the stipulation of facts and attached exhibits.

Petitioners are husband and wife and resided in Washington, D.C., at the time they filed their petition in this case. They timely filed a joint Federal income tax return for the taxable year ended December 31, 1979, with the Internal Revenue Service Center, Philadelphia, Pennsylvania.

From about March 1975 until the present time, petitioners have been the fee simple owners of an approximately 61.3270-acre tract of land known as Friendship Farm which is located in Scott District, Fauquier County, Virginia.

By deed, dated October 9, 1979, petitioners conveyed to the Virginia Outdoors Foundation (Foundation) an open-space easement in gross over Friendship Farm, including the right in perpetuity to restrict the use, development, and subdivision of Friendship Farm (the easement gift). The deed specifically provided, in relevant part, that:

> 3. The property shall not be subdivided in any manner.
>
> * * * * * *
>
> 6. No building, structure, or mobile home shall be built or maintained on the property other than (i) farm buildings or structures, and (ii) a single-family dwelling and outbuildings commonly or appropriately incidental thereto, including garaging, swimming pool, guest houses, servants' quarters and farm laborers' quarters.[1]

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[1] The deed of gift contained several other restrictions dealing with accumulation of trash etc., display of billboards etc., management of timber, grading etc., and industrial or commercial

The easement gift is legally valid in accordance with the terms thereof and is binding on petitioners and "their heirs, successors and assigns." Petitioners did not receive consideration from the Foundation for the easement gift.[2]

During all relevant periods, the Foundation was an organization described in section 170(c)(2).[3] It was created by an Act of the General Assembly of the Commonwealth of Virginia to promote the preservation of open-space lands.

Friendship Farm is located in the Middleburg Area of Virginia which is widely regarded as a wealthy and prestigious section of Virginia containing many large country estates. The subject property lies on the easterly side of Virginia Route 709 ("Zulla Road"), approximately 4 miles south of the town of Middleburg, and approximately 43 miles due west of Washington, D.C. Zulla Road is a paved public street maintained by the Virginia Department of Highways and Transportation.

As of October 9, 1979, Friendship Farm was improved by a three-bedroom dwelling, a woodshed, guest cottage, swimming pool, equipment shed, three frame barns, and another frame building. The donation of the easement did not affect the value of the improvements on the subject property, which the parties have agreed was $175,000 as of late 1979.[4]

Fauquier County assessed the value of Friendship Farm for real estate tax purposes before and after the easement gift as follows:

	1979	*1980*
Land (market value)	$177,840	$145,480
Improvements	97,360	97,360

Section 1.170A-1(c)(1), Income Tax Regs., provides, in relevant part, that "If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the

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activities except farming. Neither party has focused on the effect of such restrictions on th value of the easement gift.

[2] We note that respondent reserved the right to argue that petitioners did in fact receiv consideration for their donation of the easement. However, we conclude that there is nothin in the record to support such a finding, nor does respondent make such argument on brief.

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 195 as amended and in effect during the year in issue, and all Rule references are to the Tax Cour Rules of Practice and Procedure.

[4] Accordingly, unless otherwise noted, all references hereinafter made to the value Friendship Farm refer only to its land.

contribution." Fair market value, as defined by the regulations, "is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs.

Unfortunately, since most open-space easements are granted by deed of gift there is rarely an established market from which to derive the fair market value. See, e.g., *Thayer v. Commissioner*, T.C. Memo. 1977-370; see also *Hilborn v. Commissioner*, 85 T.C. 677, 688 (1985) (valuation of facade easement). Accordingly, it is usually necessary to value such an easement by applying a "before and after" analysis, i.e., a comparison of the fair market value of the property before the conveyance of the easement with the fair market value of the property after it is encumbered, with any diminution of value to be ascribed to the fair market value of the easement itself. See *Stanley Works and Subsidiaries v. Commissioner*, 87 T.C. 389 (1986); *Hilborn v. Commissioner*, *supra* at 688; *Akers v. Commissioner*, T.C. Memo. 1984-490, affd. 799 F.2d. 243 (6th Cir. 1986); *Thayer v. Commissioner*, *supra*. The parties have agreed that the "before and after" approach is the proper way to value the instant easement gift.[5]

We initially focus on the second part of the equation, i.e., ascertaining the fair market value of Friendship Farm after it was encumbered by the open-space easement. This exercise requires little deliberation, for the parties not only agree that the highest and best use of the property after the easement gift was as a country estate, but their respective experts are in almost total agreement as to the value of the land as such an estate. Petitioners' expert, Edward Wright (Mr. Wright), placed Friendship Farm's after value at $200,000, while respondent's experts, Peter Moholt (Mr. Moholt) and John Davidson (Mr. Davidson), estimated the property's value to be $204,000 and $202,379, respectively. Given the very narrow range of differences, we think it appropriate to find that the after-gift value of

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[5] This method has been approved by the Internal Revenue Service, see Rev. Rul. 73-339, 1973-2 C.B. 68, as clarified by Rev. Rul. 76-376, 1976-2 C.B. 53, and endorsed by Congress in connection with the adoption of the Tax Treatment Extension Act of 1980, see S. Rept. 96-1007 (1980), 1980-2 C.B. 599, 606.

Friendship Farm was $202,000. We now turn to the only remaining issue in the case, namely, the value of Friendship Farm prior to the easement gift.

The fair market value of property, by definition, should reflect the highest and best use to which such property could be put on the date of valuation. See *Stanley Works and Subsidiaries v. Commissioner*, *supra* at 400. The issue is one of fact based on the entire record (*Skripak v. Commissioner*, 84 T.C. 285, 320 (1985)), and the burden of proof as to this value is on petitioners. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).

Respondent, citing language used by petitioners' expert, Mr. Wright, defines highest and best use as the "reasonable and probable use that supports the highest present value," and urges us to find, in light of the prevalent community attitude in the Middleburg Area in 1979 against subdivision which was reflected in the then contemplated and later adopted changes in the Fauquier County zoning ordinance, that subdivision was not such a "probable use." Instead, respondent contends that the highest and best use of Friendship Farm, even before the easement gift, was as a country estate, and that the granting of the easement thus resulted in no loss in market value. In the alternative, respondent asks us to find that, even assuming arguendo that subdivision was a probable use, it was still not the property's highest and best use, because, according to respondent, the price a developer would have been willing to pay for Friendship Farm was actually less than if it was sold as a country estate (i.e., $90,722 as compared to $202,379). Petitioners, on the other hand, argue that the highest and best use of Friendship Farm before the easement gift was as a subdivided property worth $350,000 to a developer, and that the granting of the easement therefore resulted in a substantial loss in market value. Thus, our inquiry must focus first on whether subdivision was a "probable use" at all, and if so, whether it was the property's "highest and best use" so as to support the highest fair market value for Friendship Farm.

In determining the fair market value of property "The realistic, objective potential uses for property control the valuation thereof." *Stanley Works and Subsidiaries v*

Commissioner, *supra* at 400. See also *Olson v. United States*, 292 U.S. 246, 255-256 (1934). Thus, in determining the "reasonable and probable use that supports the highest present value" (see p. 400 *supra*), we focus on "The highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future." *Olson v. United States*, *supra* at 255. Moreover, "The fair market value of property is not affected by whether the owner actually has put the property to its highest and best use" (*The Stanley Works and Subsidiaries v. Commissioner*, *supra* at 400; see also *United States v. Meadow Brook Club*, 259 F.2d 41, 45 (2d Cir. 1958)), nor whether he ever intends to do so (*Akers v. Commissioner*, *supra*). Similarly, as long as the highest and best use is not prohibited by law (see *United States v. Meadow Brook Club*, *supra* at 45), community opposition to such a use does not preclude us from valuing property as if it were so used.[6]

In late 1979, at the time of the easement gift, the zoning and subdivision ordinances in Fauquier County would have permitted the subdivision of Friendship Farm. Petitioners submitted into evidence a hypothetical record plat which depicted a subdivision of Friendship Farm into 10 individual homesites. Richard McNear, who had been the director of planning and zoning of Fauquier County since 1972, testified at trial that the "plat met the requirements of the subdivision ordinance in effect in '79 and would have to have been approved by the [County] Board [of Supervisors] and committed to record. The subdivision process is a ministerial function, not a legislative [one]." Moreover, Mr. McNear added that a developer could have sought and obtained such approval "until May 19, 1981, which is when the new zoning ordinance was official [sic] adopted." Thus, at the time of the easement gift, petitioners had an unqualified legal right to subdivide Friendship Farm. Accordingly, we now turn to the issue of the fair market value of Friendship Farm as a subdivided parcel of land.

First, some general observations. While we agree with respondent that Mr. Wright's before-gift valuation was excessive, we reject Mr. Davidson's conclusion that the conveyance of the open-space easement had no adverse effect on the fair market value of Friendship Farm and that the property could not have commanded a higher purchase price absent the encumbrance. Not only did the easement prohibit any subdivision of Friendship Farm, but it also restricted the future construction of any additional dwellings on the land (see p. 893, *supra*), effectively "locking in" all future owners of the property. Thus, even assuming that in October 1979 there was no demand in the Middleburg Area for a 10-homesite subdivision, we are hard pressed to imagine a prospective purchaser of a 60-plus acre parcel of land who would not have considered the restrictions of such an open-space easement in determining his offering price. The fact that a purchaser of Friendship Farm would have been precluded from even giving away part of his land if he ever so desired, for example, to his children, or, along the same lines, precluded from ever building an additional home on his property, would certainly have affected the purchase price he would have been willing to pay.[7]

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[6] We recognize that such community opposition, as well as the impending zoning changes, might well have impacted on the ultimate purchase price Friendship Farm would have brought on the open market, see p. 898 *infra*. However, such considerations go to the fair market value of the property as a subdivision, not whether subdivision itself was a "probable use."

We also note that, despite the acknowledged community attitude against subdivision, there was a ready demand for smaller, individual lots in the Middleburg Area in 1979 Even Mr. Moholt and Mr. Davidson admitted as much at trial. Moreover, while it can be argued, in light of the added risks stemming from the uncertainty surrounding the im pending zoning changes which were the subject of much public debate in late 1979, that a developer might have insisted on paying less for the property, this argument cuts both ways; for it is equally likely that a developer might well have paid a higher price for the opportunity to get in "under the wire" and secure approval of a record plat prior to the proposed changes, in order to be able to market his subdivision as the last, or at least one of the last, such developments available in the Middleburg Area.

Both Mr. Wright and Mr. Davidson[8] based their respec tive subdivision analyses on the assumption that a developer would purchase the land and subdivide the property.[9] In arriving at their opinions of fair market value, each expert first determined what he considered to be the value of the land on the retail market, i.e., the per-acre price that a willing buyer, desiring a small homesite tract in the Middleburg Area, would have paid a developer for an already subdivided piece of land. Mr. Wright determined this average per-acre price to be $8,462.83 (total price $519,000), while Mr. Davidson determined a $3,295.04 per-acre figure (total price $202,075). These gross figures were then reduced to account for the costs of development, including sales commissions and the developer's profit margin. The gross figures were further adjusted by a 15-percent annual discount figure to account for the length of the period deemed necessary to sell all of the homesites.[10] The bottom line figure after these adjustments, $350,000 for Mr. Wright and $90,722 for Mr. Davidson, reflected each expert's opinion of what a developer would have paid for Friendship Farm.

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[7] We note that Mr. Moholt concluded that, even absent subdivision, i.e., as a country estate the easement would have resulted in a decrease in market value equal to $11,000.

[8] Although we have considered Mr. Moholt's report with respect to the property's value as country estate after the easement gift (see p. 896 *supra*), we have disregarded his valuatio analysis with respect to the before-gift value of Friendship Farm as a subdivision, since hi study failed to consider subdivision as a probable use.

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[9] Although Mr. Wright and Mr. Davidson assumed, for purposes of their analyses, that the property could be subdivided into 10 and 9 homesites, respectively, after careful consideration of the various drainage experts' reports and the testimony offered at trial, we are inclined to accept as more persuasive than those of the other experts, the testimony of respondent's expert Mr. Hencken that the soil conditions on Friendship Farm would have permitted construction of perhaps only 3 to 5 homes on the property, in addition to the existing homesite.

We recognize that, since this would have resulted in an increase in the average size of each subdivided lot, it could be argued that the per-acre retail price a developer could have commanded on the open market might, in turn, have decreased. However, it is also entirely possible that, in reconfiguring the record plat to account for this reduction in total homesites, a developer could have combined the interior lots found on the old subdivision plat with those located on Zulla Road, thus resulting in lots all with Zulla Road frontage. This would likely have increased the value of the interior acreage. Moreover, in such a situation, a substantial portion of the development costs associated with providing access to the interior lots would have been eliminated. Although we recognize the difficulties of applying judicial expertise to such a highly technical problem (see *Thayer v. Commissioner*, T.C. Memo. 1977-370), in light of all these factors, we are of the opinion that Mr. Hencken's findings would not have had any substantial effect on the average per-acre price of Friendship Farm. In this connection, we note that none of respondent's expert witnesses quantified the effect of a lesser number of homesites which they claimed would be available upon a subdivision of Friendship Farm.

[10] The appraisal difficulties which arise when dealing with long sell-out periods, which are subject to the risks of market fluctuations, are minimized in the instant case given the relatively short period of time the experts assumed would be necessary to sell out the Friendship Farm subdivision (2 to 3 years depending on which report is relied upon). Compare *Akers v. Commissioner*, 799 F.2d 243 (6th Cir. 1986), affg. a Memorandum Opinion of this Court (16-year sell-out period). We have determined that the sell-out period in this case would be 2 years with an average discount of 15 percent over that entire period, since we conclude that it was likely that sales of lots would be more or less evenly distributed over the 2-year period.

To determine the retail value of the subject property, each expert utilized a valuation method commonly referred to as the market data or comparable sales approach. As its name implies, this valuation technique requires the appraiser first to examine sale prices of comparable properties in the same general geographic area and then to adjust these comparable sales by such factors as time, location, and physical characteristics, to name but a few, so as to arrive at the value of the subject property. Under ideal circumstances, such as is the case with a tract development where there is an abundance of truly comparable sales made under similar conditions, only minor adjustments are required and the value is easily derived. However, as in the instant case, when such conditions do not exist and the appraiser is forced to compare what are essentially noncomparable sales of property (which, to a large extent, is the situation in this case), many factors come into play and more adjustments are required. As might be expected, this results in a more subjective value, highly dependent on the independent judgment of the individual appraiser. Accordingly, we think it useful to point out those distinctive characteristics of Friendship Farm, gleaned from both the record and the Court's observations,[11] which have influenced our decision herein.

The property has the general shape of a right triangle, with its longest side fronting Zulla Road (approximately 3,093 feet), which is considered one of the most prestigious addresses in the Middleburg Area. This extensive frontage on Zulla Road, coupled with the property's gentle sloping topography which affords excellent views of the Bull Run mountains to the east and the Blue Ridge mountains to the west, makes Friendship Farm an ideal subject for subdivision. Moreover, on the western side of Zulla Road, directly across from Friendship Farm, lies a 121-acre piece of property known as Salamander Farm. Prior to 1979, a perpetual open-space easement was placed upon this property (Salamander easement) and donated to the Virginia Outdoors Foundation. The easement restricted subdivision of Salamander Farm into no more than 2 tracts of land, neither of which shall consist of less than 50 acres. The building restrictions contained in the Salamander easement are identical to those found in petitioners' deed of easement (see p. 893 *supra*), except that, in the event of subdivision, they would apply to each of the subdivided parcels. Thus, the easement effectively guarantees to any future owners of Friendship Farm not only an unobstructed western view of the Blue Ridge mountains into perpetuity,[12] but equally importantly, that no major subdivision development will ever occur across the road. In either instance, the existence of the easement was a valuable selling point which would have enhanced the value of the subject property. Congress has recognized that such an impact of a conservation easement may be taken into account. See S. Rept. 96-1007 (1980), 1980-2 C.B. 599, 606.

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[11] The trial judge was invited to make a personal inspection and did so, accompanied by counsel for the parties.

Keeping the foregoing characteristics in mind, we conclude that Mr. Wright's presentation constituted a more comprehensive and better overall analysis of the potential value of Friendship Farm as a subdivision. We think he used good judgment in choosing his comparable sales (he focused on sales of smaller tracts approximate in size to the proposed homesite lots found on the record plat[13]), and, notwithstanding the fact that some of his adjustments were clearly too large, we think he correctly seized upon the distinctive characteristics of Friendship Farm in making his adjustments. Moreover, Mr. Wright, as compared to Mr. Davidson, performed his appraisal with a constant eye towards what was properly the basic underlying assumption of such a study—the potential subdivision of Friendship Farm.

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[12] Respondent argues that Mr. Davidson correctly ignored the Salamander easement in making his adjustments, in light of the fact that, even under the terms of the easement, an owner of Salamander Farm could construct a dwelling or plant a row of tall trees up close to Zulla Road, thus blocking the view to be enjoyed by any future homeowners of Friendship Farm. We think it highly unlikely that a property owner of a 50-acre-plus parcel of land would opt to locate his home virtually on top of the main road (in fact, the existing home was set far back on the property) or desire to destroy his own expansive view to the east by planting tall, obstructive trees.

[13] We recognize that many large acreage sales were also discussed at trial and several were acknowledged by the experts to be fairly "comparable" to the subject property. However, these sales would only have significance as comparables if we were engaging in an analysis of the value of Friendship Farm as a country estate, and in fact were only evaluated in the expert reports with respect to that type of analysis. Therefore, while we have utilized this testimony in categorizing the types of adjustments to be considered in arriving at the estimated value of the subject property under the comparable sales approach (e.g., the effect of being located on Zulla Road), we have not otherwise viewed them as persuasive indications of the value of Friendship Farm as a subdivided property.

Mr. Davidson, on the other hand, failed to give subdivision use the careful attention we think it deserved. We were unable to determine by what method he arrived at the retail price per acre used as the basis of his valuation conclusions, because he failed to correlate the list of more than 70 allegedly comparable sales contained in his report. Nor did his testimony at trial afford the Court sufficient meaningful clarification. Not only did Mr. Davidson give no indication as to the weight he placed on each of these sales or as to what adjustments he made, but most of these sales involved lots in subdivisions outside the Middleburg Area which were not at all comparable to Friendship Farm.[14] The inadequacy of his analysis becomes even more accentuated in light of his exhaustive study of allegedly comparable sales with respect to his discussion of the before-gift value of the property as a country estate. See note 13 *supra*. All in all, we found Mr. Davidson's analysis unconvincing. Accordingly, we have afforded it little weight, and have placed much greater emphasis on Mr. Wright's study. We note at this point that, although we have previously indicated that we are inclined toward accepting the more persuasive expert valuation (*Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 452 (1980)), we have also made it clear that we are not required to accord such valuation total acceptance (*Parker v. Commissioner*, 86 T.C. 547, 562 (1986)).

While we agree with Mr. Wright's underlying analysis, as we alluded to above, we think his upward adjustments were too large. The small acreage sales he focused upon in his report indicate a range in value from $4,000 to $5,600 per acre,[15] with his adjustments in large measure based on the $5,600 per-acre sale. To these figures Mr. Wright applied his adjustments so as to arrive at an average per-acre price exceeding $8,000, which we consider to be excessive. We think that Mr. Wright over-emphasized the significance of the $5,600 sale. Moreover, while we agree with his use of a 10-percent-per-annum adjustment over a 2-year period for appreciation (the time factor), we think he overadjusted for the distinguishing characteristics of Friendship Farm as well as for the additional adjustments for the characteristics of each of the 10 lots into which he thought the property could be subdivided. In light of the foregoing, as well as the possibilities of community opposition (see note 6 *supra*), and a somewhat lesser price per acre as the consequence of fewer lot sites being available (see note 9 *supra*), we have concluded that a price of $4,600 for comparable sales is a more appropriate figure. We adjust this figure upward for 20-percent appreciation and a further approximate 35 percent ajustment in the resulting figure for the distinguishing characteristics of Friendship Farm and the differing characteristics of the individual lots. The result is a $7,450 (rounded off) price per acre. After accounting for a 26-percent reduction for development costs[16] and a 15-percent discount for the time value of money (see note 10 *supra*), we

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[14] Moreover, based upon the evidence adduced at trial, we are of the opinion that the Zulla Hills subdivision, located on Zulla Road a few miles south of the subject property, was not comparable to the proposed subdivision of Friendship Farm. For example, the deed of each Zulla Hills' homesite required that no single or multistory home be built on any lot with less than 3,000 or 2,000 square feet of ground-level living space, respectively—homes much too large and costly to build given the land on which they were to be located. Accordingly, this had an adverse effect on the price per acre. Furthermore, Zulla Hills is located in a physical depression which deprives that property of the scenic views enjoyed by Friendship Farm. In view of the foregoing, we have given little weight to the sale of Zulla Hills lots in arriving at our determination of the before-gift value of Friendship Farm.

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[15] These sales are summarized as follows:

Date of sale	*Size (in acres)*	*Price per acre*
1/78	10	$4,000
10/77	6	4,167
10/77	5	5,600

Moreover, we note that in May 1980, Captain Brown, a neighboring landowner, and Mr. Symington each purchased a 3.374 acre tract of land adjacent to Friendship Farm from a Mrs. Tousignant, for $6,750 and $6,758 per acre, respectively. Mr. Symington and Captain Brown purchased this land so as to preclude Mrs. Tousignant from selling it as a single parcel to an outside purchaser intent on constructing a home on it. While we have not considered these to be truly comparable sales, in light of the circumstances under which they were purchased, they were arm's-length transactions, and we think that the purchase prices are at least indicative of the price per acre that the market would bear. We also note that these parcels were inferior to the subject property, in that they had ingress and egress problems, and no frontage on Zulla Road.

[16] In this regard, we have evaluated the differences between Mr. Wright's and Mr. Davidson's calculations of development costs and have concluded that Mr. Wright's overall calculation of approximately 26 percent is more persuasive than that of Mr. Davidson's, which ranges from 30 percent to 34 percent depending on the method of calculation.

In calculating these percentages, we have eliminated the $15,000 item for an interior road in light of our conclusion that such a road would probably not be needed with the reduction in the number of available homesites. See note 9 *supra*.

arrive at $4,800 (rounded off) per acre as the fair market value of Friendship Farm on October 9, 1979, or a total of $294,370. Subtracting $202,000 as the after-gift value (see p. 895 *supra*), the fair market value of the open-space easement donated to the Virginia Outdoors Foundation was $92,370.

One final word. We are appalled at the time and energy both the parties and the Court have had to expend in the course of trial and decision in this case. The foundation which produced this situation is one which, several years ago, caused us to comment as follows:

> Too often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiations—a process clearly more conducive to the proper disposition of disputes such as this. The result is an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement. * * * [*Messing v. Commissioner*, 48 T.C. 502, 512 (1967).]

See also *Buffalo Tool & Die Mfg. Co. v. Commissioner*, *supra* at 451-452.

Our approach has had a mixed application by the Circuit Courts of Appeal. Compare *Akers v. Commissioner*, 798 F.2d 894 (6th Cir. 1986), revg. and remanding a Memorandum Opinion of this Court ("the random walk approach") with *Commissioner v. Marshall*, 125 F.2d 943, 946 (2d Cir. 1942), revg. on other grounds 43 B.T.A. 99 (1940) (" 'value' involves * * * a guess, a prediction, a prophecy"). See also *Cannon v. Commissioner*, 533 F.2d 959 (5th Cir. 1976), affg. a Memorandum Opinion of this Court, and particularly Clark, J., dissenting at page 962. We have endeavored, in this opinion, to set forth the underpinnings for our ultimate determination so as to provide, in the event of an appeal, a "trail for the appellate court to follow" (see *Akers v. Commissioner*, 798 F.2d at 897), but we are constrained to note that, to a large degree, these underpinnings also reflect Solomon-like pronouncements, albeit at an earlier phase of decision. The bottom line is that we are more than ever convinced that valuation cases should be disposed of by the parties by way of settlement or other procedures short of court proceedings.

Decision will be entered under Rule 155.

JACK S. JAMES AND CAROL N. JAMES, ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 27360-83, 33287-83, 24045-84, 29714-84, 30508-84, 40635-84, 40636-84. Filed October 29, 1986.

Ps are members of a joint venture (JV). JV purported to purchase from one of a group of related companies (the Communications Group) certain computer equipment subject to existing leases. The Communications Group had purchased the computer equipment at issue from the manufacturers, arranged third-party lender financing for the equipment, and leased the equipment. After selling the equipment subject to the leases to JV, the Communications Group managed the leases as JV's "agent" and charged JV implementation, management, and performance fees. By virtue of agreements between JV and the Communications Group, cash-flow during the terms of the leases was negative despite unexplained rental income allocated to JV by the Communications Group that was greater than the amount of rent due under the leases. Under the most optimistic expectations of residual value, JV could not anticipate a profit from the transactions. *Held*, the transactions between JV and the Communications Group were independent of and unaffected by the underlying lease transactions between the Communications Group and third-party lenders and lessees and were without economic substance; JV acquired no interest in the computer equipment. *Held, further*, the investment tax credits and business expense deductions claimed by Ps as members of JV were properly disallowed.

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[1] Cases of the following petitioners are consolidated herewith: Glen E. and Sybil H. Michael, docket No. 33287-83; David G. and Kathleen Ownby, docket No. 24045-84; Jack S. and Carol N. James, docket No. 29714-84; A.F. Boudreau, Jr., and Katherine F. Boudreau, docket No. 30508-84; Jeffrey H. and Mary E. Cope, docket No. 40635-84; and Robert S. and Phyllis H. Cope, docket No. 40636-84.

Tom G. Parrott and *Charles N. Woodward*, for the petitioners.

Osmun R. Latrobe, for the respondent.

WILLIAMS, *Judge*: In these consolidated cases, the Commissioner determined deficiencies in petitioners' Federal income taxes and additions to tax for the taxable years 1979, 1980, and 1981, in the following amounts:

Docket No.	*Petitioner*	*Year*	*Deficiency*	*Sec. 6653(a) additions to tax*
27360-83	Jack S. and Carol N. James	1979	$349,785.90	---
29714-84	Jack S. and Carol N. James	1980	397,201.90	---
		1981	269,325.97	---
33287-83	Glen E. and Sybil H. Michael	1979	211,680.00	---
		1980	297,691.00	---
		1981	230,108.50	---
24045-84	David G. and Kathleen Ownby	1980	12,214.00	---
		1981	10,798.00	---
30508-84	A. F. Boudreau, Jr., and Katherine F. Boudreau	1980	639,054.27	---
40635-84	Jeffrey H. and Mary E. Cope	1980	132,314.00	$6,615.70
		1981	86,069.00	4,303.45
40636-84	Robert S. and Phyllis H. Cope	1980	175,125.00	8,756.25
		1981	148,978.00	7,448.90

After concessions by the parties, the issues which this Court must decide are whether petitioners, as members of a joint venture, are entitled (1) to investment tax credits pursuant to section 46(e)(3)[2] on certain computer equipment purportedly acquired by the joint venture; and (2) to deductions for management fees pursuant to section 162.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioners Jack S. and Carol N. James resided in Tulsa, Oklahoma, at the time their petition in docket No. 27360-83 was filed, and in Santa Barbara, California, at the time their petition in docket No. 29714-84 was filed. The remaining petitioners each resided in Tulsa, Oklahoma, at the time their respective petitions were filed.

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[2] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, unless otherwise indicated.

The principal actors in these cases are three related companies, each of which performs substantially the same functions: Communications Associates, Inc. (CAI), Communications Associates Leasing, Inc. (CALI), and Communications Leasing International, Inc. (CLI). Petitioner claims that these three companies (collectively, the Communications Group) analyzed and configured computer systems for large-scale users, purchased the computer equipment for these systems, then leased the equipment to the users.

In the transactions at issue in these cases, the Communications Group purchased and leased computer equipment and initially administered the leases covering the equipment. The Communications Group neither analyzed the needs of the users in the transactions at issue in these cases nor configured the computer equipment chosen by the lessees.

Jack James (James) was the president of CAI and CLI in 1979 and 1980. Glen E. Michael (Michael) was senior vice president of CALI in 1979 and president of CALI in 1980. The Communications Group employed an administrative staff of approximately 15 persons and used experienced independent contractors for professional assistance. In 1981 Mentco Corp. (Mentco) took over the administration and management of the portfolios of leases in which the Communications Group had continuing responsibilities.

The record does not reveal what common ownership, if any, there was between Mentco and the Communications Group. James' son is an officer of Mentco. Mentco and the Communications Group have the same address.

CLI purchased from the Amdahl Corp. (Amdahl) an Amdahl 470V/7 computer system, serial number 10055 (Amdahl 10055), on June 19, 1979, for $3,211,000, which CLI financed by executing an installment note in favor of Amdahl. The first 18 monthly payments due under the note were $56,000 each; the remaining 44 payments were $69,000 each. A final payment of $258,917 was due on March 1, 1985. CAI and Amdahl executed a security agreement covering the equipment to secure CLI's obligation to Amdahl.

CAI leased the Amdahl 10055 to Massey-Ferguson, Inc. (Massey-Ferguson), for a term of 62 months, commencing January 1, 1980. The rental rate was $56,000 per month for the first 18 months of the lease and $69,000 per month for the remainder of the lease term. Massey-Ferguson remitted the rent directly to Amdahl which satisfied CLI's monthly payments due Amdahl under CLI's installment note.

By letter dated October 24, 1983, Massey-Ferguson canceled the lease as of December 31, 1984. The parties stipulated that on November 1, 1983, Massey-Ferguson subleased the Amdahl 10055 to Major Computer, Inc. The record has only a draft sublease dated November 1, 1983, between Massey-Ferguson and Major Computer, Inc., for the sublease of the Amdahl 10055, for a term of 15 months, at a monthly rate of $7,000.

Another lease of the Amdahl 10055 was executed between Mentco Corp. (on behalf of CAI) as lessor and Major Computer as lessee on November 1, 1983, for a term of 9 months, at a monthly rate of $7,000. Attached to the lease in the record is an undated, unexecuted certificate of acceptance. The commencement date of the lease is not in the record. An addendum to the lease provided that the lessee could purchase the equipment at the conclusion of the lease by paying its then fair market value.

Each lease of the Amdahl 10055 was a net-net-net lease, under which the lessee was responsible for all costs relating to the installation, maintenance, taxes, and insurance of the computer equipment. The lease provided that "LESSOR IS NOT A MANUFACTURER OR VENDOR OF THE EQUIPMENT." The Communications Group played no role in the selection or configuration of computer equipment by the lessees. The lease was negotiated at arm's length and reflected competitive terms and rates. We find, based on the parties' agreement, that the residual value of the computer equipment at the end of the lease term would not exceed 35 percent of the manufacturer's original sales price.

CAI purchased from Amdahl a second 470V/7 computer system, serial number 70078 (Amdahl 70078), at a cost of $2,550,000 on December 28, 1979, financed by a loan from the State Street Bank. CAI leased the equipment to Amdahl for a term of 3 months, commencing January 1, 1980, then sold it to Northern Illinois University (NIU) pursuant to a "lease" that was, in fact, a conditional sales contract.

CAI transferred its interest in the Amdahl lease and the NIU conditional sales contract to CALI, for no consideration, on December 28, 1979. The NIU conditional sales contract was subsequently assigned to the State Street Bank. NIU remitted annual payments due under the NIU contract, in the amount of $394,976.76 per year, directly to the State Street Bank. On or about July 1, 1984, NIU exercised its option to pay off any remaining indebtedness encumbering the computer system and to acquire title to the Amdahl 70078, for an additional $1.

Petitioners in these cases are members of two joint ventures. Although petitioners treated the two joint ventures as one and named it "Petroleum Trading and Transport Joint Venture Number One," in fact the joint ventures had different members and involved different transactions that were separately documented. For convenience, therefore, we will identify them—as described more fully below—as JV#1 and JV#2.

JV#1 was formed on December 28, 1979, by Petroleum Trading & Transport Co. (PTT), an Oklahoma corporation controlled by A.F. Boudreau, Jr. (Boudreau); Michael Leasing Co. (MLC), a partnership owned equally by Glen E. and Sybil H. Michael; and Jack S. James (James).

JV#1 executed a purchase agreement with CALI on December 28, 1979, under which CALI purported to sell to JV#1 the Amdahl 10055 subject to the lease to Massey-Ferguson (the 1979 transaction).[3] The purchase price of JV#1's purported interest in the Amdahl 10055 was $2 million. JV#1 financed the purported purchase by executing a promissory note payable on demand in the principal amount of $300,000 and a recourse installment note in the principal amount of $1,700,000. JV#1 was also obligated to pay CALI an implementation fee of $150,000. The record does not indicate how this amount was financed by JV#1. The equipment was subject to Amdahl's priority security interest securing CLI's $3,211,000 note.

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[3] There is some confusion with respect to whether the purchase agreement covered the Amdahl 70078 or the Amdahl 10055. Petitioners argue that the equipment purchased was the Amdahl 10055, leased to Massey-Ferguson, and that the documents which refer to the Amdahl 70078, "leased" to NIU, are in error. Although the record is not entirely clear, we find that the Amdahl 10055 was the subject of the 1979 transaction.

The purchase agreement stated that CALI sold to JV#1 "all of Seller's right, title and interest in and to the Equipment, subject to a security interest therein to the Lending Institution and subject to the assignment of Seller's right to receive rental payments from the Lessee of the Equipment." However, JV#1 acquired only a 52.6-percent interest in the equipment, as interests in the equipment were sold by CAI and CALI to other investors as well. CALI and CAI received proceeds from investors totaling $3,801,250 in connection with the purported sale of the Amdahl 10055. The agreement also provided that CALI would have a "nonexclusive right to remarket" the equipment. On remarketing the equipment CALI would be entitled to receive 25 percent of the net proceeds of such remarketing.

JV#1 and CALI executed two other agreements on December 28, 1979—an agency agreement and an administrative services agreement. The agency agreement stated that CALI was authorized to acquire computer equipment suitable for lease to a user of such equipment and to lease the equipment to such users as the nominee of JV#1. The agency agreement provided that JV#1 was not personally liable in any manner on CALI's obligation to Amdahl incurred to finance CAI/CALI's acquisition of the equipment. The administrative services agreement stated that CALI would perform various administrative functions involved in the leasing of the computer equipment purchased by JV#1. Management fees for these services were due annually in the following amounts:

Dec. 28—	
1981	$72,000
1981	57,600
1982	48,000
1983	39,600
1984	39,600
1985	39,600
1986	39,600

A restated administrative services agreement between JV#1 and CALI, dated June 30, 1982, canceled the earlier agreement as of December 28, 1982. The restated agreement pooled rent from equipment covered by CAI's and CALI's administrative service arrangements with JV#1 and other similar investors with rent from leases of equipment owned by CAI or CALI. The record does not identify the equipment or leases owned by CAI or CALI, the rent from which was pooled pursuant to the restated agreement. The restated agreement provided that rental income would be allocated to the participating investors pursuant to a formula. JV#1's share of pooled income was determined by multiplying the gross pool income by a fraction representing the ratio between JV#1's investment and total investment in the pooled equipment. This figure was then multiplied by a "TR Factor," supposedly to adjust for such differences as useful life and maturity in the pooled equipment. The result was JV#1's pro rata share of pooled income (adjusted pool rental income). James, president of CALI and a member of JV#1, was unable to describe at trial how the TR Factor was determined.

Pursuant to the restated agreement, the management fee schedule of the original administrative services agreement was canceled, and management fees were set at a rate of 16 percent of adjusted pool rental income. The restated agreement also provided that the "Normal Rental Rate" of the equipment was 21.619 percent of the investment of JV#1. If gross pool income exceeded the Normal Rental Rate, CALI was entitled to retain the excess as a "performance fee," in addition to its management fees.

During the years 1980 through 1984, annual statements to JV#1 reported that JV#1's rental income on the Amdahl 10055 and obligations with respect thereto were as follows:

Year	*Rental income*	*Obligations*
1980	$452,008.51	$452,008.51
1981	437,608.51	437,608.51
1982	428,008.51	428,008.51
1983	452,380.00	452,380.07
1984	452,243.48	452,243.55

The obligations represented payments of principal and interest due on JV#1's installment note in the principal amount of $1,700,000, payments due for management fees, and payments due on a promissory note executed December

27, 1979. It is not clear from the record what the December 27, 1979, promissory note was for; the principal amount and term are unknown, but annual payments of $30,811.51 were due under it. Lease revenue and management fee calculations for the years 1983 and 1984 were calculated pursuant to the income pooling arrangement described in the restated administrative services agreement of June 30, 1982.

JV#1 was initially capitalized with demand promissory notes aggregating $300,000 bearing interest at a rate of 10 percent per year which were paid on February 29, 1980. PTT contributed $200,000; MLC contributed $50,000, and James contributed $50,000.

The joint venture agreement states that interests of the members in gross income earned by JV#1 through December 28, 1986, are as follows:

PTT	47.6%
MLC	26.2
James	26.2

The interests of the members in JV#1 gross income earned after December 28, 1986, including gross proceeds from the sale of the Amdahl 10055, are stated to be as follows:

PTT	50%
MLC	25
James	25

As stated in the joint venture agreement, the interests of the members in the obligations and liabilities of JV#1 are as follows:

(1) On a promissory note in the principal amount of $300,000, with interest at 10% per year, issued to CALI by JV#1 and paid on February 29, 1980:

PTT	$\frac{2}{3}$
MLC	$\frac{1}{6}$
James	$\frac{1}{6}$

(2) On an installment note in the principal amount of $1,700,000.00 issued to CALI by JV#1:

PTT	47.06%
MLC	26.47
James	26.47

(3) On all other obligations and liabilities of JV#1 the interests were stated as follows:

PTT	50%
MLC	25
James	25

A second joint venture (JV#2) was formed on January 15, 1980, by amendment to the joint venture agreement governing JV#1. The seven members of JV#2 are PTT, MLC, James, Boudreau, David G. Ownby, Robert S. Cope, who worked for Boudreau, and Jeffrey H. Cope, son of Robert S. Cope. Some of the members of JV#2, viz, Boudreau (as an individual), Robert S. Cope, Jeffrey H. Cope, and David G. Ownby, had no interest in the computer equipment in which JV#1 had its interest. JV#1's 1979 transaction was independent of JV#2's transaction, which were the subject of a separate, unrelated agreement. Separate annual statements of account were provided for JV#1's transaction and for JV#2's transaction.

In 1980, JV#2 purported to buy from CALI three computer systems subject to leases: (1) An Amdahl system leased to Duke Power Co. (Duke Power); (2) an IBM system leased initially to Union Metal Manufacturing Co. (Union Metal); and (3) an IBM system leased to Empire Detroit Steel (Empire Detroit). CAI or CALI purchased the computer equipment from the manufacturers in separate transactions.

CAI purchased an Amdahl system on October 31, 1980. CAI paid the full purchase price of $2,750,000 by check. CAI executed a short-term promissory note on November 5, 1980, payable to the Fourth National Bank of Tulsa in the amount of $1,761,214, secured by the Amdahl equipment. The note was refinanced by a long-term, nonrecourse note to the Philadelphia National Bank in the amount of $3,550,465.20, executed on January 19, 1981, and secured by the Amdahl equipment. The first payment under this note was due on February 1, 1981, in the amount of $105,100. Monthly payments for the ensuing 44 months were each due in the amount of $78,983 and for the remaining 36 months each in the amount of $42,686.

CAI leased the equipment to Duke Power for a term of 84 months pursuant to a lease dated October 1, 1980. The equipment was installed and accepted by Duke Power on November 1, 1980, and CAI permitted Duke Power 30 days without rent for complex system testing. The rental rates were $39,800 per month for the first 48 months of the lease and $20,666 for the remaining 36 months of the lease term. Pursuant to an operating agreement dated October 1, 1980, Duke Power could elect to terminate the lease after 48 months. Duke Power gave CAI notice of such election on October 1, 1980. On October 2, 1980, Duke Power rescinded this election in accordance with the terms of the operating agreement. On October 31, 1980, CAI assigned to CALI its interest in the equipment under the Duke Power lease, subject to the security interest held by the Philadelphia National Bank. The equipment remained under lease to Duke Power as of December 1985.

CAI purchased an IBM system, originally ordered by Union Metal, in two transactions on November 12 and November 18, 1980, for a price of $208,174. IBM had assigned to CAI the right to purchase the equipment on October 6, 1980. CAI gave two nonrecourse installment notes in the amounts of $81,071.33 and $78,921.48, and dated December 1980 and January 1981, respectively, to finance the purchase of the equipment. The record does not show how the balance of the purchase price was paid. The notes were payable to the Midlantic National Bank (Midlantic), and were secured by the IBM equipment. On October 31, 1980, CAI assigned its interest in the IBM equipment to CALI, subject to Midlantic's security interest.

CAI leased the IBM equipment to Union Metal under two separate lease schedules executed September 4, 1980, and November 4, 1980. Each schedule set forth terms of 58 months. The master lease between CAI and Union Metal incorporating these lease schedules was executed September 3, 1980. Rental under the master lease was $4,340 per month. CAI assigned all rental payments due under the lease to Midlantic, informing Union Metal of the assignment by letter dated November 6, 1980. Union Metal accepted the assignment on November 13, 1980. The equipment was installed and accepted under the separate lease schedules on December 2, 1980, and December 16, 1980, respectively.

Subsequent to entering the lease, Union Metal declared bankruptcy. In June of 1985, the computer equipment subject to the Union Metal lease was repossessed by

Midlantic. CALI repurchased the equipment from Midlantic at a price less than the amount remaining due on CAI's nonrecourse notes with the bank dated December 1980 and January 1981, respectively.

CALI purchased another IBM system for $347,110 on December 15, 1980. CAI had ordered the equipment from IBM and transferred its interest in the equipment to CALI for no consideration on October 31, 1980. CALI paid IBM by check on February 16, 1981. CAI financed the purchase through a promissory note in the amount of $347,110 to the Fourth National Bank of Tulsa. CALI refinanced the purchase by executing a nonrecourse installment note payable to the Philadelphia National Bank in the principal amount of $347,109.85 on March 16, 1981, secured by the IBM equipment. The first payment under this note was due April 1, 1981, in the amount of $6,220.72. The remaining 58 monthly payments were each due in the amount of $8,534.79.

CALI leased the equipment to Empire Detroit and assigned its right, title, and interest in the Empire Detroit lease to the Philadelphia National Bank. The original term of the lease was 60 months, commencing February 1, 1981, at a rate of $9,413 per month. Monthly rental payments were remitted directly to the Philadelphia National Bank by Empire Detroit, commencing March 1, 1981.

On July 10, 1981, CALI informed Empire Detroit by letter that the original lease term of 60 months was in error. CALI submitted an amended lease schedule with a term of 58 months, but also stated that "should you determine that you will need this equipment for the 59th and 60th month and even longer, we will allow an extension at no increase in rate." The monthly rental rate of $9,413 was not changed. The lease was in effect as of December 1985.

The leases in each of the three 1980 transactions were net-net-net leases and provided that "LESSOR IS NOT A MANUFACTURER OR VENDOR OF THE EQUIPMENT." All transactions were negotiated at arm's length, and all contracts reflected competitive terms and rates. The parties have stipulated that the residual value of the equipment, at the end of each lease term, did not exceed 35 percent of the manufacturer's original sales price.

CALI purported to sell to JV#2 the three computer systems, subject to the leases, pursuant to a purchase agreement executed on October 31, 1980 (the 1980 Agreement). The purchase price of the equipment was $3,800,000, financed by a demand note for a downpayment of $817,000, which was satisfied on December 31, 1980, and an installment note executed by JV#2 in the principal amount of $2,983,000 payable to CALI. JV#2 also incurred an implementation fee of $57,000, financed by a recourse demand note executed by JV#2 and payable to CALI. The note was paid December 31, 1980. As with JV#1's 1979 transaction, under the 1980 Agreement, JV#2 gave CALI a "nonexclusive right to remarket" the equipment, for which it would receive a 25-percent commission.

JV#2 and CALI executed an administrative services agreement on October 31, 1980, under which CALI agreed to administer the leases purportedly transferred to JV#2 by the 1980 Agreement. The rental income allocated to JV#2 was calculated under terms identical to the pooling arrangement provided by the 1982 restated administrative services agreement between JV#1 and CALI. The management fee due CALI was likewise set at the rate of 16 percent of the adjusted pool rental income received.

JV#2's allocation of pooled rental income and obligations pursuant to the 1980 Agreement were stated by Mentco as follows:

Year	*Rental income (pooled)*	*Obligations*
1980	$125,812.81	[1]$125,844.01
1981	744,114.41	744,106.42
1982	763,845.41	763,837.43
1983	763,083.39	763,075.40
1984	762,574.49	762,566.52

[1] This figure excludes the $817,000 downpayment for the equipment, financed in the form of a promissory note to CALI from JV#2 due and payable in one installment on Dec. 29, 1980, and the $57,000 implementation fee, financed in the form of a promissory note to CALI from the JV#2 also due and payable in one installment on Dec. 29, 1980.

Obligations of JV#2 included payment of CALI's management fee and payments of the principal and interest on JV#2's $2,983,000 promissory note to CALI.

In connection with their downpayment under the 1980 Agreement, the members of JV#2 contributed the following amounts to the joint venture:

PTT	$11,362
MLC	69,046
James	69,046
Boudreau	229,862
Robert S. Cope	298,908
Jeffrey H. Cope	173,052
David G. Ownby	22,724

Interests of the members in the profits and liabilities of JV#2 arising out of the 1980 Agreement were as follows:

PTT	1.3%
MLC	7.9
James	7.9
Boudreau	26.3
Robert S. Cope	34.2
Jeffrey H. Cope	19.8
David G. Ownby	2.6

JV#1 and JV#2 filed partnership information returns for each of the taxable years at issue in these cases as a single joint venture, Petroleum Trading and Transport Joint Venture No. One (PTTJV).

OPINION

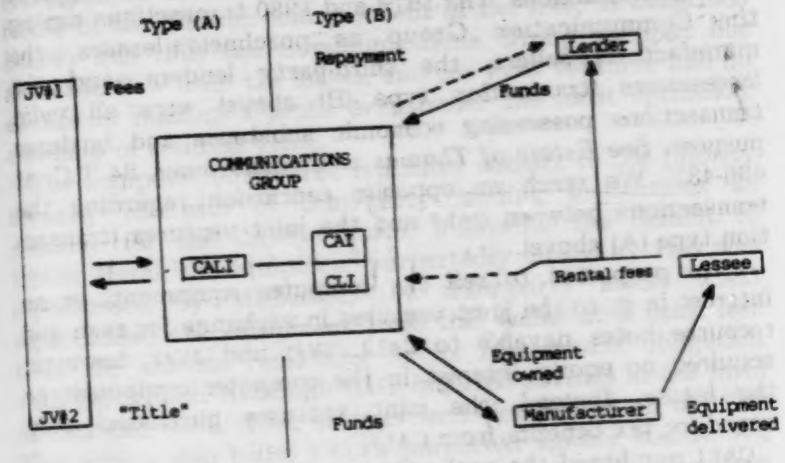
Petitioners argue that the members of JV#1 and of JV#2 each entered the ventures with the purpose of realizing a profit from their investment in computer equipment and that the joint ventures were engaged in a trade or business or in an activity for profit. Petitioners argue that their interests in the computer equipment were purchased from the Communications Group and would have a significant residual value at the conclusion of the lease to which the equipment was subject. Therefore, they contend that they are entitled to the investment tax credit and business expense deductions claimed on their returns.

Respondent contends that the transactions at issue in these cases lacked economic substance and business purpose, that petitioners in these cases lacked a profit motive, and that the sole purpose of entering into the transactions at issue was tax avoidance. On this basis, respondent urges that the transactions should be disregarded as shams for Federal income tax purposes.

A transaction is without its intended effect for Federal income tax purposes if (1) it is a sham, being a mere paper chase or is otherwise fictitious (*Falsetti v. Commissioner*, 85 T.C. 332 (1985)), or (2) the transaction is devoid of economic substance consonant with its intended tax effects (*Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978); *Knetsch v. United States*, 364 U.S. 361, 366 (1960)). The substance of the transaction, not its form, determines its tax consequences. The transaction must have economic substance which is "compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance—features that have meaningless labels attached." *Frank Lyon Co. v. United States*, 435 U.S. at 583-584; *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985); *Hilton v. Commissioner*, 74 T.C. 305 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982).

It must be recognized that the tax laws affect the shape of every business transaction. The parties to a transaction are entitled to take into account and to maximize favorable tax results so long as the transaction is compelled or encouraged by non-tax business reasons. *Frank Lyon Co. v. United States*, 435 U.S. at 580.

The form of the transactions at issue in these cases is that JV#1 and JV#2 purchased computer equipment subject to leases from CALI (type A below). Respondent argues that, in substance, JV#1 and JV#2 acquired no economic interest in the equipment or the leases but merely purchased tax benefits from CALI. Respondent concedes that the transactions involving CAI/CLI, the manufacturer, the lender, and the lessee, are typical purchase and lease transactions having economic substance and business purpose (type B below). A diagram of the transactions in these cases is as follows:


Type (A)
Type (B)
Repayment
Lender
JV#1
Fees
Funds
COMMUNICATIONS GROUP
CAI
CALI
CLI
Rental fees
Lessee
Equipment owned
JV#2
"Title"
Funds
Manufacturer
Equipment delivered

Respondent argues that transaction type (A), involving JV#1/JV#2 and CAI/CALI, has no business or economic relationship to transaction type (B) and is without economic substance or business purpose; in short, that neither JV#1 nor JV#2 owned the equipment bought and leased in transaction (B). Petitioners respond that CAI/CALI acted as agents for the joint ventures, and that the joint ventures were an integral element of the substantive transaction type (B). We agree with respondent's view.

The Communications Group purchased the computer equipment, obtained long-term, nonrecourse financing for the purchases, gave the lending institutions priority security interests in the equipment purchased, leased the equipment to various lessees, and assigned to CALI their respective interests in the equipment and the leases covering the equipment. These purchases were negotiated at arm's length and reflected competitive market prices. Similarly, the leases covering the equipment reflected competitive terms and rental rates.

Net-net-net leases are commonly negotiated in equipment leasing transactions. The 1979 and 1980 transactions among the Communication Group as purchasers-lessors, the manufacturers-sellers, the third-party lenders, and the lessee-users (transaction type (B) above) were all valid transactions possessing economic substance and business purpose. See *Estate of Thomas v. Commissioner*, 84 T.C. at 436-437. We reach an opposite conclusion regarding the transactions between CALI and the joint ventures (transaction type (A) above).

CALI purported to sell the computer equipment, or an interest in it, to the joint ventures in exchange for cash and recourse notes payable to CALI. JV#1 and JV#2, however, acquired no equity interest in the computer equipment or the leases. Instead, the joint ventures purchased only hoped-for tax benefits from CALI.

CALI purchased the proportionate share of the equipment that it purported to sell to JV#1 in the 1979 transaction for $1,689,444.21. JV#1 paid $2 million for its interest. CALI purchased the equipment that it purported to sell to JV#2 in the 1980 transaction for $3,305,284. JV#2 paid $3,800,000 for its interest. The joint ventures, therefore, paid CALI an approximate 15-percent markup over manufacturer's price. Petitioners argue that the markup in price compensated CALI for its services in configuring, acquiring, and leasing the equipment, and reflected the enhanced value of the equipment as a result of CALI's services. The record, however, is barren of evidence to support petitioners' contention that the value of the equipment was enhanced subsequent to its acquisition by CALI. Whatever might have been CALI's general business practices in other transactions, in the transactions at issue CALI did nothing to add value to the equipment. Employees of the lessees testified that CALI did not participate in their leasing transactions except to arrange financing.

CALI's price markup is inconsistent with the actions of one acting as an agent considering that the joint ventures also paid CALI substantial fees in each transaction, including "implementation fees," "management fees" and "performance fees." CALI was more than fully compensated for its services to the joint ventures by the implementation and management fees it received from JV#1 and JV#2. The net result of the markup and payment of the fees, as discussed below, was that the Communications Group stripped out any cash-flow from the leases, and the joint ventures had no chance of making a profit even under the most optimistic estimate of residual value.

The computer equipment remained subject to the priority security interests of third-party lending institutions as security for the CAI/CLI loans. Following the default of Union Metal, the equipment purportedly owned by JV#2 was repossessed by Midlantic, the third-party lender. CALI repurchased the equipment from the lender at a price less than the amount remaining on its nonrecourse obligation with the lender. Although CALI incurred savings in the form of canceled debt, these savings were not passed on to JV#2. This action also belies CALI's purported agency status. We conclude that CALI was a principal acting for its own account. Consequently, the joint ventures' transactions with the Communications Group must stand on their own footing and do not inherit through CALI any of the business substance that exists in the transactions between the Communications Group and the manufacturers, lenders, and lessee-users.

Further, we note that the documentation of the 1979 transaction indicates that JV#1 purchased the Amdahl 70078, leased first to Amdahl, and subsequently sold to Northern Illinois University. This documentation includes not only the documents at the time of the purported sale in 1979, but also the restated administrative services agreement in 1982 and the annual statements from Mentco. Petitioners claim that this documentation was in error, which error was discovered in 1984 and corrected as petitioners prepared for trial. This indicates to us that some of the petitioners (who were members of both JV#1 and JV#2) did not exercise normal care in ascertaining which equipment they "owned," where it was located, or which lessee had leased the equipment. This imprudent conduct suggests that the business substance of these leasing transactions was not of primary concern to petitioners.

Moreover, the arrangement between JV#1 and CALI is imbued with inexplicable anomalies. The rental income allocated to JV#1 was from the 1979 lease of the Amdahl 10055 to Massey-Ferguson which called for a monthly rental of $56,000 for the first 18 months of the lease and $69,000 for the remainder of the lease term. For 1980 JV#1's rental income should have been its representative share of the rent generated by the lease: namely, $353,472 (52.6 percent of $672,000). This figure is approximately $98,000 less than that which was actually allocated to JV#1. In 1981 and 1982, the rental rates under the Massey-Ferguson lease rose, while actual rental income allocated to JV#1 decreased. We find no evidence in the record to account for these discrepancies. Income "pooling" did not commence until 1983.

All the transactions at issue generated zero cash-flow to the joint ventures during each year at issue in these cases. During the years 1980 through 1984, JV#1 received statements reporting the following net returns with respect to the 1979 transaction:

	1980	*1981*	*1982*	*1983*	*1984*
Rental income:	$452,008.51	$437,608.51	$428,008.51	$452,380.00	$452,243.48
Obligations:	(452,008.51)	(437,608.51)	(428,008.51)	(452,380.07)	(452,243.55)
Net return:	0.00	0.00	0.00	(0.07)	(0.07)

JV#1 received no statement for the year 1979, and CALI allocated no "rental income" for the year 1979 to JV#1. Considering the $150,000 implementation fee that JV#1 paid CALI, JV#1's out-of-pocket cash requirements, not counting the downpayment, were $150,000.14.

The cash-flow to JV#2 also was zero during each of the years 1980 through 1984. Discrepancies between rental income allocated to JV#2 and that due under the leases covering the equipment pursuant to the 1980 Agreement are similar to the discrepancies in the record regarding JV#1's 1979 transaction. Income "pooling" was, however, in effect for JV#2's transaction from its inception.

Perhaps most importantly, the administrative services agreements served to assure that cash-flow during the terms of the various leases would be enjoyed only by CALI.

Each agreement provided that if rental income allocated to the joint ventures pursuant to the pooling arrangements exceeded the "Normal Rental Rate" the excess would be retained by CALI as a "performance fee." The record again has no evidence of any performance that would justify the fee. We believe that the fee enabled CALI to enhance its own equity interest in the equipment and leases.

Since cash-flow during the lease terms was zero, the residual value of the computer equipment is the sole source of potential profit. Petitioners anticipated that the residual value of the equipment would not exceed 35 percent of the manufacturer's original sales price. The parties stipulated a broad range of actual values of between zero and 35 percent of the manufacturer's original price reflecting the significant degree of speculation and uncertainty in the computer leasing market. However, looking to the most optimistic residual values anticipated, we find that petitioners could not generate any net return on their investment in the joint ventures.

For these joint ventures to generate a profit, the residual values to be realized on remarketing the equipment must exceed the sum of the downpayment on the equipment, the implementation fees paid to CALI, and the 25-percent commission[4] due to CALI for remarketing the equipment. The residual value of the equipment is a percentage of the "manufacturer's original sale price"—the price between the manufacturer and CAI. Consequently, the return to JV#1 on the remarketing of the equipment purchased in the 1979 transaction would be as follows:

	$1,689,444.21
Manufacturer's original price[1]	×.35
Residual value	591,305.47
Gross proceeds	(300,000.00)
Downpayment	(147,826.36)
25% Commission to CALI	(.14)
Cash-flow	

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[4] Petitioners allege that the equipment could be remarketed by someone for less than the 25-percent commission to CALI. The joint ventures played no role in the purchasing, leasing, or servicing of the equipment. CALI knew the location, status, and condition of the equipment, and we believe that petitioners did not. We believe it is a fair inference that the only one likely to have any role in the remarketing of the equipment would be CALI. Anticipating the 25-percent commission as cost associated with petitioners' investment is, therefore, appropriate.

Implementation fee	($150,000.00)
Net profit (loss)	(6,521.03)

[1]Since JV#1 "purchased" only a portion of the Amdahl 10055, the manufacturer's original price is calculated in the following manner:

$$\frac{{}^{1}\$2,000,000}{{}^{2}\,3,801,250} \times {}^{3}\$3,211,000 = \underline{\underline{\$1,689,444.21}}$$

(Proportionate share of manufacturer's price to JV#1)

[1]Sales price to JV#1 (including the lease).
[2]Total investment in the Amdahl 10055.
[3]Manufacturer's original sales price, paid by CAI to the manufacturer.

The return on the remarketing of the equipment purchased in the 1980 transactions would be as follows:

Manufacturer's original price[1]	$3,305,284.00
Residual value	×.35
Gross proceeds	1,156,849.40
Downpayment	(817,000.00)
25% Commission to CALI	(289,212.35)
Cash-flow	(.27)
Implementation fee	(57,000.00)
Net profit (loss)	(6,363.22)

[1]This price represents the sum of those paid for the three systems separately purchased by CAI and leased to Empire Detroit, Duke Power, and Union Metal. The parties aggregate these transactions as do we. A different result is not suggested by examining these transactions separately.

Even assuming realization of the maximum residual values anticipated, the joint ventures would realize a net loss. We conclude that (1) there was no objective possibility that the transactions at issue in these cases would be profitable and (2) that petitioners' transactions were without economic substance.

The transactions between the joint ventures and CALI were independent of and unaffected by the transactions that occurred between the Communications Group, the manufacturers, the lenders, and the lessees. The transactions between the joint ventures and CALI were structured so that no prospect of achieving a non-tax profit from the transactions existed at the time the joint ventures entered into them.[5] The joint ventures acquired no interest in the computer equipment or the leases covering that equipment. Instead, the joint ventures merely purchased a package of tax benefits from CALI.

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[5]The circumstances of this case do not warrant application of the subjective business purpose test of *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983) affd. in part, revd. in part 752 F.2d 89 (4th Cir. 1985). Petitioners were sophisticated investors who should have known that the transactions at issue could not achieve a non-tax profit.

Petitioners have failed to establish that the joint ventures owned the equipment on which they claimed investment tax credits. Because petitioners did not acquire any interest in the computer equipment the investment tax credits at issue in these cases were properly disallowed.

Disallowance of the claimed management fee deductions also follows. The management fees established under the administrative services agreements bore no apparent relation to the actual services performed by CALI. Through the annual management fees, including the "performance fee," petitioners attempted to meet the 15-percent test of section 46(e)(3)(B) to qualify each transaction for the investment tax credit but achieved only to strip cash-flow from the leases for CALI's benefit. The joint ventures were not engaged in these transactions for profit.

To reflect concessions by the parties,

Decisions will be entered pursuant to Rule 155.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, and PARR, *JJ.*, agree with this opinion.

GERBER and WELLS, *JJ.*, did not participate in the consideration of this opinion.

ADITYA B. MUKERJI AND SWATAI MUKERJI, ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 34129-84, 39312-84 7386-85. Filed October 29, 1986.

Petitioners, individual investors, each purchased computer equipment from C, or C's wholly owned subsidiary. Petitioners then leased the equipment to C for a term of 7 years. At the time of purchase, the equipment was subject to prior leases between C and corporate end-users. The purchase price was paid with cash and largely recourse notes. *Held*, the transactions herein are not shams and have economic substance.

Edward C. Rustigan, *Joel V. Williamson* and *Thomas C. Durham*, for the petitioners.

Michael W. Bitner, for the respondent.

FAY, *Judge*: Respondent determined deficiencies in and additions to petitioners' Federal income tax liability as follows:

			Additions to tax		
Petitioners	*Year*	*Deficiency*	*Sec. 6653(a)(1)*[2]	*Sec. 6653(a)(2)*	*Sec. 6659*
Aditya B. and	1981	$4,488	$224	(*)	$1,346
Swati Mukerji	1982	23,189	1,159	(*)	6,957
Charles F. and	1980	16,641	832	...	0
Judith Hurchalla	1981	23,537	1,177	(*)	0
Larry B. and Beverly W. Thrall	1981	20,868	0	0	0

* To be determined.

After concessions by petitioners and the severance of another issue in docket No. 34129-84 pursuant to Rules 61(b) and 141(b),[3] the sole remaining issues in the instant cases are (1) whether petitioners are entitled to various deductions claimed in connection with certain computer equipment; (2) whether petitioners Aditya B. Mukerji and Swati Mukerji and petitioners Charles F. Hurchalla and Judith Hurchalla are liable for additions to tax under section 6653(a)(1); (3) whether petitioners Aditya B. Mukerji and Swati Mukerji and petitioners Charles F. Hurchalla and Judith Hurchalla are liable for additions to tax under section 6653(a)(2); (4) whether petitioners Aditya B. Mukerji and Swati Mukerji are liable for additions to tax under section 6659; and (5) whether petitioners are liable for the additional interest amount determined under section 6621(d).

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[1] Cases of the following petitioners are consolidated herewith: Charles F. Hurchalla and Judith Hurchalla, docket No. 39312-84; and Larry B. Thrall and Beverly W. Thrall, docket No. 7386-85. Furthermore, the instant cases control several hundred cases currently at the administrative level which are held in suspense pending the outcome of these cases.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] See *Noonan v. Commissioner*, T.C. Memo 1986-449.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioners Aditya B. Mukerji and Swati Mukerji resided in Piedmont, California, when they filed their petition herein. Petitioners Charles F. Hurchalla and Judith Hurchalla resided in Exton, Pennsylvania, when they filed their petition herein. Petitioners Larry B. Thrall and Beverly W. Thrall resided in Los Angeles, California, when they filed their petition herein.[4]

Each petitioner purchased computer equipment during the years in issue and leased such equipment to Comdisco, Inc. (herein Comdisco), for a term of 7 years. For clarity, we will separately state the facts of each transaction.

The Mukerji Transaction

Petitioner Aditya B. Mukerji (herein Mukerji) was employed in 1982 by Bateman Eichler, Hill Richards, Inc. (herein Bateman Eichler), as a vice president in charge of institutional investment, dealing with institutional investors with respect to fixed income investments.

In 1982, Mukerji purchased various items of used computer equipment from CDC Sales & Leasing, Inc. (herein CDC), a wholly owned subsidiary of Comdisco, for a total purchase price of $150,000, plus $2,475 in fees and commissions. Mukerji purchased the following items of computer equipment, all of which were manufactured by IBM:

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[4] "Petitioners" or "petitioner," as used hereinafter, refers only to the male petitioners unless otherwise indicated.

Item	*Quantity*	*Purchase price*
3880-1 Storage control unit		
8170 Two channel switch	2	$148,000
3340-A2 Disk drive storage unit	1	2,000

Mukerji made a cash downpayment of $5,813 on December 5, 1982. For the remainder of the purchase price, Mukerji executed two recourse promissory notes with CDC, one in the sum of $18,975 (herein promissory note) and the other in the amount of $127,687 (herein installment note). Mukerji made payments under the promissory note as follows:

Date	*Principal*	*Interest*
May 15, 1983	$11,574	$651
May 15, 1984	7,401	1,526

The installment note was payable in seven annual installments with the first payment to commence on January 1, 1984.

Mukerji also executed a security agreement whereby he assigned a security interest in the equipment and other collateral to CDC as security for his obligation under the installment note and the promissory note. Immediately after the purchase, Mukerji leased to Comdisco the equipment under a net lease for a term of 7 years ending on December 31, 1989. The lease executed between Mukerji and Comdisco was a net lease in that Comdisco agreed to pay property taxes and certain other taxes, insurance, and maintenance costs. The use of net leases is a standard commercial practice in the computer industry. Upon the expiration of the lease, Comdisco would tender the equipment to Mukerji at a location designated by Mukerji.

At the time Mukerji purchased his equipment, each item of equipment was subject to an existing lease between Comdisco and an end-user which became a sublease upon Mukerji's purchase of the equipment. Both of the 3880-1 storage control units were subject to a sublease to North Carolina National Bank. The 3340-A2 disk drive storage unit was subject to a sublease to Schweber Electronics Corp. Mukerji was aware of North Carolina National Bank's financial position and was favorably impressed.

Payments of rental obligations (herein basic rent) by Comdisco to Mukerji under the equipment lease are due in seven annual installments, beginning on January 1, 1984, and ending on January 1, 1990, and exactly matched in timing with the payments under the installment note Mukerji made with CDC. The amount of basic rent payments due from Comdisco pursuant to the terms of the lease agreement also exactly matched Mukerji's debt payments under his installment note with CDC.

In addition to Comdisco's obligation to pay basic rent for 7 years, the lease agreement between Mukerji and Comdisco also provides that beginning on January 1, 1987, Comdisco would be obligated to pay "additional rent" to Mukerji. Additional rent is defined in such lease agreement as an amount equal to 100 percent of the gross rentals actually received by Comdisco from sublessee end-users of Mukerji's equipment, until Mukerji has received $15,248 (10 percent of the purchase price of his equipment, plus fees and commissions). Thereafter, Mukerji would receive an amount equal to 50 percent of the gross rentals actually received by Comdisco from sublessee end-users. Additional rent would be payable quarterly and would constitute a positive cash flow to Mukerji, i.e., cash receipt after the payment under the installment note.

Comdisco's obligation to pay basic rent to Mukerji is unconditional and is not contingent upon Comdisco's success in subleasing Mukerji's equipment. Although the amount of additional rent which Comdisco was obligated to pay Mukerji would be measured by the amount Comdisco receives from its sublessees, the obligation to pay such additional rent is that of Comdisco and not that of Comdisco's sublessees.

Mukerji's purchase was part of a program structured by Comdisco and Bateman Eichler which offered purchasers the opportunity to purchase packages of IBM peripheral computer equipment in a leveraged sale-leaseback transaction.[5] Bateman Eichler served as the dealer-manager of this program which was made pursuant to a private placement memorandum dated November 5, 1982.[6]

Mukerji first became aware of the offering from an internal memorandum prepared by the tax advantaged investment department of Bateman Eichler which was circulated to Bateman Eichler's account executives. Through his employment with Bateman Eichler, Mukerji was aware that in selecting investment opportunities, Bateman Eichler relied upon both its internal resources and upon outside experts. Bateman Eichler's internal resources included its tax advantaged investment department and a 15-member research department. Becoming somewhat interested, Mukerji attended a meeting arranged for Bateman Eichler account executives at which the Comdisco offering was discussed in detail. After this meeting, Mukerji discussed further the Comdisco offering with members of Bateman Eichler's tax advantaged investment department. Mukerji also spoke with Bateman Eichler's vice president in charge of computer industry research. He reviewed several research reports on Comdisco, the private placement memorandum distributed with respect to the offering in 1982, and private placement memoranda which had been distributed in previous equipment offerings by Comdisco.

In his examination of the private placement memorandum, Mukerji paid close attention to the financial projections therein which set forth the positive cash-flow, rental obligations, tax aspects, debt service, and similar information. Mukerji reviewed and relied upon an appraisal contained in the private placement memorandum that was prepared by Kenneth B. Steinback (herein Steinback). Steinback is the president of Computer Sales International, Inc., a dealer and lessor of new and used data processing equipment and a member of the Computer Dealers/Lessors Association. Such appraisal discussed both the then-current fair market value of the equipment described in the memorandum and its projected residual value as of the end of 1989 (the termination of Mukerji's lease to Comdisco). Such appraisal also contained Steinback's opinion with respect to the amount of cash-flow a purchaser might expect pursuant to a percentage rental provision in the lease Mukerji subsequently executed with Comdisco.

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[5] Peripheral computer equipment, as explained more fully below, feeds information into and out of the central processing unit of a computer.

[6] The private placement memorandum provided for the sale of a maximum of 667 packages of equipment worth approximately $150,000 each, or a total of approximately $100 million worth of equipment.

Mukerji was aware that the equipment involved in the Comdisco offering was peripheral computer equipment which historically had a longer economic life than mainframe equipment or central processing units.

The private placement memorandum stated that "The principal objectives of a purchaser of an Equipment package should be realization of a cash return from rentals under the Lease during the later years of the Lease and on the re-leasing or sale of the Equipment at the end of the Lease, and the utilization of anticipated tax benefits during the terms [sic] of the Lease." The memorandum also contained a detailed description of the secondary market for IBM computer equipment, including the factors affecting the residual value of peripheral equipment. This description included a chart which displayed historical residual values of certain items of IBM peripheral equipment.

The private placement memorandum estimated that the residual value of the equipment after the 7-year lease with Comdisco will be at least 10 percent of the purchase price of $150,000, or $15,000, on Mukerji's out-of-pocket cash investment of $24,788. The estimate in the private placement memorandum is consistent with Mukerji's conclusion after his review of the documents and his discussions with Bateman Eichler's personnel. Mukerji was also advised that the fair market value appraisals of the equipment offered for sale in the private placement memorandum were conservative estimates.

The private placement memorandum estimated that net tax savings at the end of the term of the lease with Comdisco would be $13,481 on Mukerji's initial cash investment of $24,788. The private placement memorandum shows that in 1987 the transaction would reach a "turn around" point after which Mukerji would pay increased taxes as a result of entering into the transaction. Based on the private placement memorandum, any additional rent or residual value received by Mukerji will further reduce the net tax savings of his investment. Net tax savings were calculated on the assumption that a 50-percent tax rate would apply to the taxable income or loss resulting from each year of the transaction.

On their 1982 joint Federal income tax return, petitioners Aditya B. Mukerji and Swati Mukerji claimed a depreciation deduction of $22,500 with respect to their computer equipment purchased from CDC. Respondent disallowed such deduction in his notice of deficiency issued July 2, 1984.[7]

The Hurchalla Transaction

On his Federal income tax return for 1981, petitioner Charles F. Hurchalla (herein Hurchalla) listed his occupation as "executive." Hurchalla holds a master's degree in business administration from Temple University, and in 1981 he was the owner and president of Petron Trading Co., an oil marketing and trading firm.

On December 30, 1980, Hurchalla executed an equipment purchase agreement with Comdisco for the purchase of used computer equipment for $198,400 plus fees and commissions in the amount of $3,968. The items of equipment (all manufactured by IBM), purchased by Hurchalla and the purchase price of each, are set forth below:

Item	*Quantity*	*Purchase price*
3350-A2 Disk drive storage unit	1	$40,000
3350-B2 Disk drive storage unit	5	158,000

Hurchalla made a cash downpayment of $9,920 on December 27, 1980. Pursuant to an option to defer payment provided in the equipment purchase agreement, Hurchalla made subsequent cash payments to Comdisco as follows:

Date	*Principal*	*Interest*
Feb. 4, 1981	$20,832	$416.64
Feb. 10, 1982	12,896	1,805.44

To finance the remaining portion of the purchase price of his equipment, Hurchalla executed an installment note with Continental Illinois National Bank & Trust Co. of Chicago (Continental Bank) in the principal amount of $158,720.

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[7] Respondent also made other adjustments in his notice of deficiency. The only issue here, however, is the depreciation deduction with respect to the equipment.

Hurchalla also executed a security agreement pursuant to which he assigned a security interest in the equipment and other collateral to Continental Bank as security for his obligations under the installment note.[8] The installment note with Continental Bank was a recourse note to the extent of 79.5 percent of the principal amount in that Hurchalla's personal liability for repayment of that portion of the note was not limited. However, the first 20.5 percent of the principal amount of the note was payable only from Comdisco's obligation to pay rent and the collateral contained in the security agreement.[9]

Immediately after Hurchalla purchased his equipment from Comdisco, he leased it back to Comdisco for a term ending on December 31, 1987. Hurchalla's lease with Comdisco was a net lease. Upon the expiration of the lease, Comdisco will tender the equipment to Hurchalla at a location designated by Hurchalla. At the time Hurchalla purchased his equipment, each item of equipment was subject to an existing lease between Comdisco and American Telephone & Telegraph Communications, Inc., which became a sublease upon Hurchalla's purchase of the equipment.

Through March of 1986, the amount of rent which Comdisco is obligated to pay to Hurchalla pursuant to the terms of the lease agreement exactly matches the amount of debt payments which Hurchalla is obligated to make to Continental Bank pursuant to the terms of Hurchalla's promissory note. Payments on the promissory note with Continental Bank are also due on the same dates as Comdisco's rent payment to Hurchalla. Payments of rent by Comdisco to Hurchalla are due quarterly in arrears, with the first payment to be made on April 1, 1981. Succeeding payments will be due on July 1, October 1, January 1, and April 1 of each year with the last payment to be made on January 1, 1988.

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[8] Such other collateral consists of Hurchalla's rights and interest under the lease agreement, his rights to all present and future rental payments, and other amounts payable under the lease between him and Comdisco, and his rights and interest under the equipment purchase agreement with Comdisco.

[9] As stated below, Hurchalla leased the equipment to Comdisco and the amount of rental payments from Comdisco to Hurchalla match in amount and timing Hurchalla's payments under the installment note. The first 20.5 percent of the note would have been repaid completely from Comdisco's rental payments by April 1983.

Commencing April 1, 1986, quarterly rental payments under Hurchalla's lease with Comdisco will exceed Hurchalla's debt service payments to Continental Bank. Thereafter, the rent payments will provide a positive cash flow to Hurchalla in the following amounts—

Year	*Positive cash-flow*
1986	$5,776
1987	7,701
1988	1,747

In this respect, Hurchalla's transaction differs from Mukerji's in that the net cash-flow to Hurchalla is fixed and is not dependent upon Comdisco's success in subleasing Hurchalla's equipment.

Hurchalla first became aware of the Comdisco equipment offerings through his broker, Charles D'Amico (herein D'Amico). D'Amico, Hurchalla's broker for 15 years, is an employee of Moseley, Hallgarten, Estabrook & Weeden, Inc. (herein Moseley), a financial services organization offering securities brokerage and trading, investment banking, and other financial services.

Hurchalla's purchase is part of a program structured by Moseley and Comdisco which offered purchasers the opportunity to purchase packages of IBM peripheral computer equipment in a leveraged sale-leaseback transaction. This offering was made pursuant to a private placement memorandum dated November 25, 1980.[10]

At Hurchalla's request, D'Amico sent a copy of the private placement memorandum to John Devlin (herein Devlin), Hurchalla's accountant. Hurchalla reviewed the private placement memorandum which included an appraisal prepared by Richard Forsythe (herein Forsythe). Forsythe is the president of Forsythe/McArthur Associates, Inc., a broker and dealer of used IBM equipment. Such appraisal set forth Forsythe's opinions concerning both the current fair market value of the equipment described in the memorandum and its projected residual value as of the end of 1987, at the termination of Hurchalla's lease with Comdisco.

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[10] The private placement memorandum provided for the sale of a maximum of 49 packages of equipment worth approximately $200,000 each, or a total of approximately $9.8 million worth of equipment.

The financial projections which were included in the private placement memorandum showed that in 1985 the transaction would reach a "turn around" point after which Hurchalla would pay increased taxes as a result of entering into the transaction. For this reason, the net tax savings associated with Hurchalla's investment were considerably less than his initial out-of-pocket cash investment. The private placement memorandum indicated that the net tax savings for taxpayers in the 70-percent and 60-percent tax brackets would be $21,625 and $18,536, respectively. Hurchalla's out-of-pocket cash investment in the equipment purchase is $43,648.

Hurchalla is knowledgeable with respect to computer equipment. He had studied computer science and data processing in the course of earning his master's degree in business administration. In addition, during his previous employment with several oil companies, Hurchalla had worked with others on computer programs concerning oil marketing. He had also been involved with the development of a software program designed to meet the special needs of oil marketing companies and has invested approximately $50,000 in developing this program. Through upgrading his company's computer system, Hurchalla learned that peripheral computer equipment has a longer economic life than central processing units.

In the course of evaluating the Comdisco transaction, Hurchalla discussed the equipment involved with Bart Whittaker (herein Whittaker), a neighbor who worked for IBM. Whittaker told Hurchalla that he found no material errors in the appraisal of the equipment's fair market value and projected residual value. Hurchalla also discussed the value of the equipment with a neighbor who worked for Burroughs Corp. Hurchalla discussed the Comdisco offering with his attorney and Devlin. Hurchalla and Devlin together reviewed the projections of cash-flow and residual value contained in the private placement memorandum.

Hurchalla also reviewed the financial status of Comdisco and learned that Comdisco was a large customer of IBM equipment. Hurchalla was impressed by Comdisco's performance. He also learned that IBM had 70 to 75 percent of the computer market and he therefore felt comfortable in the purchase of IBM equipment. Furthermore, at the time he reviewed the private offering memorandum, Hurchalla was aware that one of the sublessee end-users of the equipment he would purchase was American Telephone & Telegraph Communications, Inc., in which he placed much confidence.

Hurchalla acknowledged that the equipment he purchased must yield a residual value of approximately 15 percent of its purchase price for him to break even on his out-of-pocket cash investment. Based upon his review of the Comdisco offering, Hurchalla expected that a purchase of the equipment described in the offering would yield a return of approximately 25 percent on his investment. Hurchalla recognized that there were risks involved in purchasing computer equipment, however, his investigation indicated that the risks in the Comdisco offering were reasonable. The appraisal letter by Forsythe in the private offering memorandum indicated that Hurchalla's equipment would be worth $39,680 in December 1987, the end of Hurchalla's lease with Comdisco. This amount, when added to the cash-flow Hurchalla could expect under the lease with Comdisco, would produce a return of $54,904 on an initial cash investment of $43,648. Hurchalla and his advisers concluded that the Forsythe/McArthur Associates, Inc., appraisal was a realistic projection of the equipment's anticipated residual value. Hurchalla understood that technological advances could make his equipment less valuable than anticipated. However, he believed that these risks were reasonable under the circumstances and recognized that similar risks are often encountered in commercial transactions.

On their 1980 joint Federal income tax return, petitioners Charles F. Hurchalla and Judith Hurchalla reported a depreciation deduction of $30,355[11] with respect to the equipment purchased from Comdisco. On their 1981 Federal income tax return, they reported a depreciation deduction of $52,272, a fee amortization deduction of $1,020, and an interest deduction of $21,444 with respect to the equipment. The 1981 return showed rental income from Comdisco of $31,722 with respect to the equipment. Respondent by notice of deficiency dated August 23, 1984, disallowed the claimed deductions.

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[11] This amount includes fee amortization of $596.

The Thrall Transaction

On his 1981 Federal income tax return, petitioner Larry B. Thrall (herein Thrall) listed his occupation as "attorney."

In 1978, Thrall became the president of International Investment Group, a real estate investment company. At the time of trial, Thrall was the managing partner of a real estate investment partnership which invests in real estate projects.

On December 17, 1981, Thrall executed an equipment purchase agreement with Comdisco for the purchase of certain used computer equipment for a total purchase price of $400,000 plus $7,000 in fees and commission. The items of equipment purchased by Thrall (all of which are manufactured by IBM), and the purchase price of each, are set forth below:

IBM model number	*Quantity*	*Purchase price*
3271-2 Control unit 3250 Device adapter 7821 4800/7200 BPS	1	$2,900
3277-2 Display station 4631 66 Key EBCDIC typewriter	12	16,800
3286-2 Printer	3	4,500
3350-A2 Disk drive storage unit 8150 String switch	2	111,600
3350-B2 Disk drive storage unit	4	158,400
3350-C2 Disk drive storage unit 8150 String switch	2	105,800

Thrall made a downpayment of $15,240 on December 22, 1981, toward the purchase of his equipment. Pursuant to an option to defer payment provided in the equipment purchase agreement, Thrall made subsequent cash payments to Comdisco as follows:

Date	*Principal*	*Interest*
May 14, 1982	$37,130	$2,088
May 13, 1983	18,630	3,842

Thrall financed the remaining portion of the purchase price of his equipment in a similar manner as Hurchalla, through an installment note with Continental Bank in the principal amount of $336,000. However, 68.1548 percent of the note executed by Thrall was recourse, and the first 31.8452 percent is payable solely out of Comdisco's obligation to pay rent and from certain collaterals contained in the security agreement.[12]

Immediately after Thrall purchased his equipment, he leased it back to Comdisco for a term ending on December 31, 1988, under arrangements similar to Hurchalla's lease arrangement with Comdisco. At the time Thrall purchased the equipment, all 12 of the 3277-2 display stations, and accompanying keyboards, were subject to an existing lease to Miller Electric Manufacturing Co. The 3271-2 control unit and all three of the 3286-2 printers were subject to an existing lease to Duracell International, Inc. Both of the 3350-A2 disk drives, both of the 3350-C2 disk drives, and all four of the 3350-B2 disk drives were subject to an existing lease to Lucky Stores, Inc.

Through 1986, the amount of rent which Comdisco is obligated to pay to Thrall pursuant to the terms of the lease agreement exactly matches the debt payments pursuant to the terms of the installment note which Thrall is obligated to make to Continental Bank (and subsequently The Former Witter Corp., successor to Continental Bank's interest).[13] Payments under the installment note are due on the same dates as the rental payments from Comdisco to Thrall. Payments of rent by Comdisco to Thrall are due annually in arrears, with the first payment to be made on January 1, 1983. Succeeding payments are due on January

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[12] As we state below, Thrall leased the equipment to Comdisco, and the rental payments are identical in time and amount to the payments under the note. The first 31.8452 percent of the note would have been repaid completely from Comdisco's rental payments by January 1986 (30.0339 percent would have been repaid by January 1985).

[13] In December of 1981, Continental Bank sold Thrall's promissory note, along with those o other purchasers of computer equipment at that time, to the Former Witter Corp. (herein Witter).

1 of each year with the last payment to be made on January 1, 1989. Beginning in 1987, Comdisco's annual rental payments to Thrall will exceed Thrall's debt payments under the promissory note. Such rent payments will provide a positive cash-flow to Thrall of $6,784 per year in 1987, 1988, and 1989. As in Hurchalla's transaction, the net cash-flow which Comdisco is obligated to pay Thrall is fixed and not dependent upon Comdisco's success in subleasing Thrall's equipment.

Thrall first became aware of the Comdisco leasing programs through Steve Griffith (herein Griffith), a broker with Bateman Eichler who advises Thrall on investments. Thrall has known Griffith for over 15 years. In addition to their professional relationship, Thrall and Griffith are close personal friends.

The Comdisco program which Griffith presented to Thrall was structured by Comdisco and Moseley in November of 1981. As in the two offerings previously discussed, purchasers were offered the opportunity to purchase packages of IBM peripheral computer equipment in a leveraged sale-leaseback transaction. The offering was made pursuant to a private placement memorandum dated November 2, 1981, and a supplement thereto, dated December 23, 1981.[14]

Thrall had recently made investments in oil and gas offerings in which he had not only lost his entire capital investment but had also been called upon to make additional payments on debts involved in those investments. Thrall did not want to repeat that experience. Therefore, protection of his capital investment was crucial in his consideration.

Thrall personally reviewed the appraisal of residual value which was contained in the private placement memorandum in the 1981 Comdisco offering. The private placement memorandum for the 1981 offering is similar in format to the private placement memorandum for the 1980 offering which Hurchalla reviewed, each containing an appraisal from Forsythe. In addition to Griffith, Thrall also asked an administrative assistant of 10 years to review the offering documents.

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[14] The private placement memorandum initially provided for the sale of a maximum of 75 packages of equipment worth $200,000 each, or a total of $15 million worth of equipment. The offering was subsequently expanded to provide for the sale of over $40 million worth of equipment.

In the course of reviewing the documents relating to the Comdisco offering, Thrall learned that peripheral equipment, such as was included in the offering, is generally less susceptible to technological obsolescence than mainframe equipment or central processing units. Furthermore, Thrall had no doubt that Continental Bank would enforce its rights under the note he executed.[15] Thrall reviewed the financial status of Comdisco, and concluded that Comdisco was a reputable company which was highly successful in the leasing business.

In reviewing the Comdisco offering, Thrall understood the risks involved and felt they were reasonable under the circumstances. Thrall understood there was a risk that he would not recover even his cash investment; however, he also understood that there was a possibility of higher residual values which would lead to a large profit.

Forsythe's appraisal letter in the private placement memorandum, which Thrall reviewed, indicated that his equipment would be worth $80,000 in December 1988. This amount, when added to the cash-flow Thrall could expect under the lease with Comdisco, would produce a return of $100,352 on an out-of-pocket cash investment of $71,000.

Although Thrall recognized that there were tax benefits associated with the Comdisco investment, particularly in the first year, he was also aware of other investments which would have produced more tax benefits for a smaller cash investment. Thrall was unwilling to make any investment strictly for tax benefits, and he had communicated this view to Griffith. Thrall learned that the Comdisco investment involved a "turn around" point after which his taxes would increase as a result of the investment. The financial projections which were included in the private placement memorandum showed that this "turn around" point would occur in 1986. As a result of the "turn around" point, the estimated net tax savings of $40,504 were considerably less than Thrall's $71,000 initial cash investment.

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[15] Respondent alluded to a pledge agreement between Comdisco and Continental Bank whereby certificates of deposit would be pledged as security for the debts of Thrall and other purchasers. The record shows that such agreement was never executed.

On their 1981 joint Federal income tax return, petitioners Larry B. Thrall and Beverly W. Thrall reported a depreciation deduction of $30,525 on a basis of $203,500 with respect to the equipment purchased from Comdisco. By notice of deficiency dated January 3, 1985, respondent disallowed the claimed deduction. In an amendment to their petition, petitioners Larry B. Thrall and Beverly W. Thrall claimed an additional depreciation deduction of $30,525 in 1981 with respect to certain computer equipment purchased by them in that year.[16]

Comdisco and Its Leasing Business

Comdisco was formed in 1969 as a broker-dealer and lessor to engage in buying, selling, and leasing new and used IBM computer equipment. Comdisco is a publicly held corporation and is listed on the New York Stock Exchange. Comdisco's revenue was $602 million in the fiscal year ending on September 30, 1985.

Comdisco is the world's largest lessor, dealer, and remarketer of IBM computer equipment that is not affiliated with any computer equipment manufacturer. Comdisco is only second in size in the computer leasing market to IBM Credit Corp. Comdisco operates in the "third party leasing" marketplace in which lessors of IBM computer equipment buy or lease IBM equipment, either from IBM or from others, and in turn lease such equipment to end-users. Comdisco's customers are, in general, the large- and medium-size users of computer equipment throughout the world. Comdisco leases equipment to every member of the top 50 companies of the Fortune 500.

Comdisco also provides a wide range of services to its customers, such as providing consultations and seminars concerning equipment needs, upgrading installed equipment, planning computer center relocations and transportation, remarketing used equipment, and providing maintenance services. One of Comdisco's latest business activities is Comdisco disaster recovery services which provides back-up data processing facilities in the event a customer's facilities are unable to function because of a fire or other disaster.

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[16] Thrall purchased two packages of computer equipment but initially only claimed a depreciation deduction for one package of equipment.

The existence of the third-party market and Comdisco's ability to remarket older generations of equipment are attributable to IBM's maintenance policy. IBM offers maintenance service for the equipment it manufactures whether it is in the possession of an IBM customer or a third party. This maintenance policy ensures that an item of equipment which is, for example, 5 years old will perform in the same manner, and be just as reliable, as a similar item of equipment which is brand new. Physical deterioration is thus not an important factor in the value of used equipment. For this reason, used market prices generally do not distinguish between the physical age of equipment of the same model and capability.

The business of leasing computer equipment is capita intensive and Comdisco has developed several methods of financing its growth. One of the company's methods for raising new capital is the financing of lease receivables. Generally, when Comdisco writes a lease with a lessee, it finances the lease by borrowing on a nonrecourse basis from a bank or other institutional lender. This debt is secured by the rental payments due under the lease and by the equipment.

The three transactions at issue represent another method which Comdisco employs to raise capital. In each of these transactions, Comdisco sold some of its equipment, thus further reducing, or eliminating, the company's capita investment in the equipment. The combination of these and other methods of financing allows Comdisco to preserve and increase its capital to grow and purchase new equipment

Description and History of the Equipment

All of the equipment involved in the three transactions herein is peripheral equipment which was manufactured by IBM. Generally, computer equipment can be divided into two broad classifications, peripheral equipment and central processing units. As noted above, peripheral computer equipment refers to the equipment in a computer system which feeds information into and out of the central processing unit. The central processing unit is the core or "brain" of a computer system which actually performs the data processing functions.

The record herein establishes that the residual value of a specific piece of computer equipment is a function of supply and demand, technological improvements in newer equipment, and the resulting gradual technological obsolescence of older equipment. In general, the rate of obsolescence is directly related to the rate of introduction of new, technologically advanced equipment.

Peripheral equipment is generally less susceptible to rapid technological obsolescence than central processing units because peripheral equipment is generally more mechanical in nature. Furthermore, older generations of peripheral equipment can be used with newer generations of central processing units. Because of the constant growth of the need for data processing services, many equipment users will replace their central processing units and add new peripheral equipment, but will also retain their previous peripheral equipment to meet the demands of growth.

Many equipment users find it advantageous to use older equipment because older equipment provides satisfactory performance at a lower cost. A very important part of Comdisco's business is its ability to remarket and derive the maximum value from older generations of equipment.

The IBM model 3350 disk drive storage units (herein 3350 disk drive) purchased by Hurchalla and Thrall are disk drive storage devices which are used to store data and programs.[17] A 3350 disk drive consists of a stack of magnetic disks on a spindle. Heads which move laterally across the disk can either record information on or read information from the disk as it rotates beneath the head. During the time of the transactions herein, the 3350 disk drive was the most widely used disk drive storage device.

An important factor in the value of the 3350 disk drive as well as that of other disk drive storage devices, is its price-performance ratio. Generally, users of data processing equipment will attempt to purchase or lease the most performance for their money. In the context of disk drive storage devices, equipment users will attempt to maximize the amount of storage capacity. As newer, more efficient models with lower price-performance ratios are introduced onto the market, the cost of older models will drop so that the price-performance of older models will remain competitive with the newest product.

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[17] A 3350-A2 is a "master" unit which is capable of managing a string of up to eight disk drives. A 3350-B2 is a "slave" unit which cannot operate without a master unit. A 3350-C2 can operate either as a slave unit or as a back-up master unit.

The 3350 disk drive was introduced on the market in 1976. During the period from 1976 through 1980, the price of the 3350 disk drive dropped, although the price remained at a relatively high percentage of IBM list price. In the fall of 1980, 3350 disk drives on the third-party market were selling at 95 percent of the IBM list price.

In June of 1980, IBM announced plans to introduce the 3380, (herein new 3380 disk drive) a new disk storage device more advanced than the 3350 disk drive. Subsequent to the announcement of the introduction of the new 3380 disk drive, however, IBM encountered substantial technical difficulties in producing such units. As a result, quantity deliveries of the new 3380 disk drives were delayed by as much as 2 years.

At the time IBM announced the new 3380 disk drive there was reason to believe that disk drive technology was maturing and that future developments in disk drive technology would be less dramatic than in the past. As is the case with all peripheral equipment, many of the functions in a disk drive are essentially mechanical and are less susceptible to technological improvement than purely electronic functions. The technical difficulties IBM encountered in producing the new 3380 disk drive were also an indication that any future breakthroughs in disk drive technology would probably be more expensive and less frequent than in the past.

As a result of the problems IBM encountered in producing and delivering the new 3380 disk drive, the demand for the 3350 disk drives increased substantially in 1980 and 1981. Due to this increased demand, the price for the 3350 disk drives on the third-party market increased to over 150 percent of the IBM list price for new equipment, and IBM raised the list price of the 3350 disk drive in December of 1981.

In 1982, IBM began delivery of the new 3380 disk drives in larger quantities. When large scale deliveries of the new 3380 disk drive commenced, the price of the 3350 disk drives began to drop to bring its price-performance ratio in line with that of the more efficient new 3380 disk drives. However, large scale deliveries of the new 3380 disk drives and the resulting price drop of the 3350 disk drive did not take place until after Hurchalla and Thrall had purchased their equipment.

The 3880 storage control unit, which Mukerji purchased, was introduced on the market in 1979. The function of the 3880 storage control unit is to control the flow of information between a string of disk drives and a central processing unit. The 3880 storage control unit translates information between the formats used in the central processing unit and translates information for recording on the disks. The 3880 storage control unit also performs other necessary control-type functions.

The 3880 storage control unit can be used to control a wide variety of IBM disk drive storage devices, including the 3350 disk drives. In addition, the 3880-1 storage control units which Mukerji purchased can be upgraded to 3880-3 storage control units for less than $3,000 per unit in the field, that is to say, without the need of removal from their on-site location. As a result of this upgrading, such units can be used with the new 3380 disk drive, IBM's most advanced disk drive technology.[18]

The value of storage control units, such as the 3880 storage control unit, generally declines in proportion to the value of the disk drives with which they are used. Since the 3880 storage control unit can easily be upgraded for use with the new 3380 disk drive, the 3880 storage control unit, once upgraded, will have a useful life equal to that of the new 3380 disk drive. The useful life of the 3880 storage control unit also reflects the fact that it can be used to control a wide variety of disk drive storage devices.

Thrall purchased a small amount of IBM 3270-series terminal equipment, which was introduced in 1972. The terminal equipment purchased by Thrall represents approximately 6.1 percent of his purchase price. In general, terminal equipment has the longest useful life of all peripheral equipment since most of the cost of terminal equipment represents mechanical functions which are not susceptible to dramatic technological improvement. Certain terminal devices have commonly been used for 20 years or more.

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[18] Any 3880-1 can be upgraded for use with new 3380 disk drives. Certain 3880-1 units with low serial numbers cannot be upgraded for use with the double-density version of the new 3380 disk drive, but may be upgraded to be used with the earlier versions of the new 3380 disk drive.

In addition to the 3880-1 storage control units, Mukerji also purchased a 3340-A2 disk drive, a smaller disk drive than the 3350 disk drive. The 3340-A2 disk drive, which was introduced in 1973, was generally used by customers with smaller data processing requirements. The 3340-A2 disk drive which Mukerji purchased represents 1.33 percent of his purchase price.

Expert Testimony on Fair Market Value

Svend E. Hartmann (herein Hartmann) testified for petitioners with respect to the fair market value of the equipment at the time it was purchased by petitioners. Hartmann is the president of Computer Merchants, Inc. (herein Computer Merchants), a position he has held since 1974. Computer Merchants is a dealer and lessor of IBM computer equipment.

In 1970, Computer Merchants began publishing a quarterly journal entitled the Computer Price Guide. The Computer Price Guide was the computer industry's first regularly published source of price and market information for both new and used computer equipment. Since 1970, Hartmann has been the editor of the Computer Price Guide. Since 1971, Hartmann has also been the author of a quarterly newsletter, the Readers Report, which is a supplement to the Computer Price Guide and which contains comments and evaluations of the current and expected market trends for computer peripheral equipment.

The Computer Price Guide is widely used by computer professionals and others who have a continuing need to remain informed about price trends and development in the marketplace for IBM computers. The Computer Price Guide is distributed to about 4,500 subscribers, including IBM executives, banks, insurance companies, leasing companies, accountants, and taxing authorities, including the Internal Revenue Service. Within the computer industry, the Computer Price Guide is commonly referred to as the "Blue Book" of prices for used computers.

The information in the Computer Price Guide is gathered by analyzing transactions entered into by dealers throughout the country with whom Computer Merchants stays in contact, and by analyzing the transactions of Computer Merchants itself. The prices in the Computer Price Guide represent Computer Merchants' best judgment as to representative retail prices at the time each issue is published.

The Computer Price Guide is published quarterly, in January, April, July, and October. Until the October 1981 issue, the Computer Price Guide was distributed to subscribers at the beginning of the month. In October 1981, the publication schedule was changed so that the issue would be distributed in the middle of the month. This revision in publication schedule was made for better coordination with the timing of IBM announcements of price changes for its equipment. Each issue of the Computer Price Guide attempts to reflect retail prices of equipment in transactions taking place immediately before each issue's publication date.

Hartmann presented his opinion concerning the fair market value of the equipment purchased by each petitioner as of the date of the offering memorandum distributed in each transaction.[19] In determining the value of each package of equipment, Hartmann first examined the October issue of the Computer Price Guide preceding each transaction and the January issue published subsequent to the date of each transaction. Through a process of extrapolation, he then determined the fair market value as of the date of each private placement memorandum.

Hartmann in his testimony and expert report refers to a "lease premium."[20] The Computer Price Guide lists prices

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[19] Therefore, Hartmann determined the value of Hurchalla's, Thrall's, and Mukerji's equipment as of Nov. 25, 1980, Nov. 2, 1981, and Nov. 5, 1982, respectively.

[20] Hartmann described the lease premium in the following terms:

"There are a number of reasons why a buyer of leased and installed equipment might be willing to pay a lease premium, or an amount in excess of the value of the equipment itself. A buyer would usually recognize that the additional costs of delivery and installation of the equipment are included in the sale price, and thus justify a higher price. The buyer would also understand that the price includes an amount for finding the user and arranging documenta- tion and financing. Finally, the existence of a lease carries with it the potential for additional revenue from lease renewals and/or lease continuations beyond the firm portion of the lease. Users have a tendency to continue to lease computer equipment that satisfies the user's needs for used equipment which is not on lease. Hartman testified that equipment which is actually on lease, however, acquires an additional element of value attributable to the fact that the equipment is in place and has the potential for additional leasing revenue from existing users beyond the firm portion of the lease.

According to Hartmann's best estimate, the lease premium for a portfolio of installed equipment on lease is an amount in the range of 5 percent to 15 percent over the market value of comparable equipment sold on the used market and not installed on a lessee's premises. Since the leases in question were being administered by Comdisco, a successful remarketer of used IBM computer equipment, Hartmann believed that an investor would be reasonable to assume that the potential for additional lease revenue, and the lease premium, would be maximized in these transactions.

Respondent's witness on the issue of fair market value was Dee Morgan (herein Morgan). Since 1943, Morgan has been employed by several corporations, including IBM and Burroughs Corp., and she has served as the director of the computer center at the University of Utah and at Dugway Proving Ground in Utah. From 1965 through 1983, Morgan was employed by the General Services Administration as a computer equipment analyst and a data processing systems coordinator. During her period of employment at the General Services Administration, part of Morgan's responsibility involved providing estimates of the residual value and economic life of computer equipment to the Defense Contract Audit Agency. Morgan retired from this position in 1983 at a grade level of GS-13.

Morgan based her opinion of the fair market value of each petitioner's equipment on the values contained in the Computer Price Guide. Morgan's opinions and testimony differed, however, in several respects from Hartmann's.

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rather than to purchase or lease new computer equipment. In making this decision to continue to lease existing equipment, the user normally will take into account the cost and inconvenience of changing the equipment. The user's costs of purchasing or leasing new computer equipment include training personnel on new equipment and in new procedures, as well as removal and installation costs. Thus, installed computer equipment normally can be expected to produce revenue at the end of its lease either because of purchase or renewal by the user, even though the same equipment offered for sale or lease on the market would not result in a realization of the same amount of rental or sales income."

First, Morgan gave her opinion of the fair market value of each petitioner's equipment as of December 31 of the year in which each transaction took place. Thus, Morgan based her opinion on the values set forth in the issues of the Computer Price Guide which were published in January following each transaction. On December 15, 1982, IBM announced a price cut in the 3880-1 storage control unit. Such price cut was reflected in the January issue of the Blue Book and was thus taken into account by Morgan in her determination of the value of 3880-1 storage control units as of December 31, 1982. Morgan used the January issue of the Computer Price Guide on the assumption that it would provide the most accurate prices as of December 31 of each year in issue, a date subsequent to the date of each private placement memorandum and the date each petitioner entered into the respective transactions.

The second area in which Morgan's analysis differs from that of Hartmann concerns the treatment of the prices set forth in the Computer Price Guide. Morgan claimed that the prices in the Computer Price Guide are "asking" prices and that actual trades take place at lower prices.[21]

Finally, Morgan did not apply a "lease premium" to the prices shown in the Computer Price Guide to ascertain the fair market value of the equipment purchased by petitioners.

The opinions of Hartmann and Morgan as to the fair market value of each petitioner's equipment, and the price each petitioner actually paid for his equipment, are set forth in the table below:

	Fair market value				
	Hartmann				
	Value without lease premium	*Value with 5% lease premium*	*Value with 15% lease premium*	*Morgan*	*Purchase price*
Mukerji	$146,971	$154,320	$169,017	$115,500	$150,000
Hurchalla	202,250	212,363	232,588	219,000	198,400
Thrall	405,499	425,774	466,324	337,940	400,000

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[21] Morgan used a factor ranging from 2 percent to 25 percent to discount the prices listed in the Computer Price Guide. On some items of equipment, she did not apply any discount factor.

Hartmann concluded that each petitioner paid a price at the low end of the fair market value range for his equipment. Morgan, however, concluded that Hurchalla paid a price below the fair market value of his equipment and that Thrall and Mukerji paid an amount in excess of the fair market value of their equipment.

Expert Testimony on Residual Value

Frederic G. Withington (herein Withington) and Esmond C. Lyons, Jr. (herein Lyons), testified for petitioners with respect to the residual value of the equipment which might reasonably be anticipated at the conclusion of each petitioner's lease with Comdisco.[22]

Withington is a vice president of Arthur D. Little, Inc., a Cambridge, Massachusetts, consulting firm. Withington is a specialist in the computer and information processing industry and has been a visiting professor at the Harvard Business School, where he lectured on advanced information processing systems. He has written 4 books and 52 articles on information processing, which have been translated into 8 languages. In his position at Arthur D. Little, Inc., Withington has been involved in preparing residual value forecasts of IBM equipment for over 20 years. Since 1964, he has also been responsible for a series of widely disseminated annual reports assessing and forecasting developments in the computer and data processing industries. The technology forecasts which Withington relied on at the trial of the instant case had been prepared at the request of both manufacturers and large customers of computer equipment, including the Federal Government.

In preparing a residual value forecast for IBM equipment, Withington takes into consideration the following factors:

—IBM's probable future successor products
—Future user requirements
—Future of the relevant technology
—IBM's worldwide business interests

In preparing his expert witness report which was introduced at trial, Withington relied solely upon forecasts which he had prepared at the time each of the three transactions at issue took place. In November of 1980, Withington had prepared a technology forecast entitled "Future Information Processing Technology" which was submitted at the request of the Defense Intelligence Agency. This report included a forecast of the specific cost of disk drive technology for the period from 1980 through 1995. Since this report was prepared in November of 1980, at approximately the same time Hurchalla purchased his equipment, it represents Withington's opinion of the future value of Hurchalla's equipment as of the date Hurchalla purchased his equipment.

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[22] In addition, Hartmann expressed his general views as to the economic life of the 3350 disk drive and the 3880 storage control unit. He did not, however, predict specific residual values for any of the equipment involved.

Withington used a similar method in expressing his opinion as to the residual value of Thrall's equipment. In November of 1981, Withington had prepared another technology forecast entitled "Future Information Processing Technology" which was submitted at the request of the Defense Intelligence Agency. This report also included a forecast of the specific cost of disk drive technology for the period 1981 through 1995. Since this report was prepared at approximately the same time Thrall purchased his equipment, Withington used this report to indicate his opinion in November 1981, concerning the future value of Thrall's disk drive equipment.

Thrall also purchased a small amount of data entry and display terminal equipment, and Withington's November 1981 report provided a projection of the future value of such equipment. Withington used this report to indicate his opinion in November 1981 concerning the future value of Thrall's terminal equipment.

Withington used two different reports to estimate the residual value of Mukerji's 3880 storage control unit. First, Withington referred to a specific residual value forecast for the 3880-1 storage control unit which he had prepared in June of 1983, 6 months after Mukerji purchased his equipment. This report was prepared for St. Joseph Equity Corp., a leasing company. In this forecast, Withington predicted that the 3880-1 storage control units owned by Mukerji would be worth $20,572 at the end of 1989 (14 percent of Mukerji's purchase price).

Since the report for the St. Joseph Equity Corp. was prepared 6 months after Mukerji's transaction, Withington used a second report to verify his estimate. In August of 1982, Withington had prepared another technology forecast which was a portion of a report entitled "Future Information Processing Technology" which was submitted at the request of the Institute for Computer Science and Technology in the National Bureau of Standards.[23] In this report, Withington prepared a forecast of disk drive technology which indicated that the value of disk drives at the end of 1989 would be equal to 12.5 percent of their August 1982 value. Since storage control units decline in value in proportion to the disk drives they control, based on this study Withington would have predicted that Mukerji's equipment would have been worth $18,500 at the end of 1989 (12.5 percent of Mukerji's purchase price).[24]

Therefore, as of December 1982, Withington testified that he would have projected a residual value of either $20,572 or $18,500 for Mukerji's equipment, with the former projection more likely since it was a specific forecast for the 3880-1 storage control unit.

Petitioner's remaining expert witness, Lyons, is the principal management consultant in the information systems division of SRI International (herein SRI), formerly known as the Stanford Research Institute. SRI is a not-for-profit corporation which is involved in technology research and management consulting for business and Government clients.

Lyons received a Bachelor of Science degree in physics and mathematics from the University of Maryland, where he was involved in programming the Univac I, the world's first commercial computer. In his position at SRI, Lyons has been responsible for providing consulting services to computer manufacturers and service companies. These consulting services include market research for planned or existing products, technology forecasts, and the development of marketing plans. The clients of SRI in this area include major computer equipment manufacturers. Due to the nature of Lyons' employment, it has been essential for him to be fully aware of IBM's technical capabilities and marketing activities.

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[23] This report was developed jointly for the Institute for Computer Science and Technology and the Defense Intelligence Agency.

[24] This report was developed jointly for the Institute for Computer Science and Technology and the Defense Intelligence Agency.

The method which Lyons used to make his predictions of residual value consisted of several steps. First, he analyzed the historical performance of similar equipment as of the time each transaction took place. Second, he reviewed current developments in computer technology, as of the time each transaction took place, and in doing so used an extensive data base maintained by SRI relative to residual values. Third, he made certain assumptions about future market conditions, again as of the time each transaction took place. In making the residual value projections he presented in these cases, Lyons relied upon the following facts and assumptions:

—The 3350 disk drive consistently sold at higher used prices at a comparable age than any predecessor disk drive product.

—Disk drive technology was approaching certain limitations which would result in more stable prices for used disk drives.

—Storage control units, such as the 3880 storage control unit, generally have used values much higher than other computer products.

Hartmann did not provide specific predictions of residual value, but he did offer general observations about the economic life of the 3350 disk drive and the 3880 storage control unit. Because of the popularity and high demand for the 3350 disk drive throughout 1980 and 1981, Hartmann testified that it would have been reasonable to assume that the 3350 disk drive would produce rental income through 1990 and beyond. Since the 3880 storage control unit can be upgraded for use with the new 3380 disk drive, Hartmann stated that the 3880 storage control unit would likely have an economic useful life of several years beyond that of the 3350 disk drive.

Morgan testified for respondent concerning her opinion as to the residual value of each petitioner's equipment. Her residual value projections were much lower than those provided by petitioners' witnesses. Morgan's method of projecting residual values is to examine the history of similar types of equipment on the assumption that current models will follow the economic performance of past models. In analyzing the residual value of the 3350 disk drives purchased by Thrall and Hurchalla, Morgan based her analysis on the assumption that no prior disk drive product ever had an economic life of longer than 14 years. Therefore, Morgan concluded that 3350 disk drives would be worthless by the end of 1989. For these reasons, Morgan testified that the residual values of the 3350 disk drives purchased by Hurchalla and Thrall would be minimal.

Furthermore, Morgan testifed that a major factor in the residual value of disk drive devices was intense competition from "plug-compatible manufacturers." A plug-compatible manufacturer produces equipment, such as disk drives, which will function with IBM components and software. Morgan testified that the competition of plug-compatible manufacturers, such as Storage Technology, Memorex, ITEL, Telex, and Control Data Corp., were driving down the value of disk drive devices. However, at the time of trial, three of these five plug-compatible manufacturers had filed for bankruptcy or withdrawn from the disk drive market.

As to the 3880-1 storage control unit purchased by Mukerji, Morgan testifed that its value would be dependent upon the economic lives of the disk drives which it is able to control. Although she testified that the 3880-1 storage control unit disk drive can be used with a wide variety of disk drives, her expert witness report and her testimony did not reflect that the 3880-1 storage control unit can be easily upgraded for use with the new 3380 disk drive. Morgan stated in her report that the 3880-1 storage control unit can be expected to have a value "as long as the newest of [the disk drives], the 3375 Disk Drive which was first installed in 1981." Morgan stated that the 3375 disk drive was installed in 1981 but probably would not have any value by the start of 1990. Morgan's report stated that Mukerji's equipment, consisting of 3880-1 storage control units and a 3340-A2 disk drive, would be worthless at the end of 1989, when the term of the lease between Mukerji and Comdisco expires.

Morgan also testified that Thrall's terminal equipment would have no possible residual value.

The conclusions of each expert witness as to the residual value of each petitioner's equipment are set forth below. In addition, the residual value predicted in the appraisal letters included in each private placement memorandum are also indicated.[25]

	Withington	*Lyons*	*Morgan*	*Appraisal letter*
Mukerji[26]	$18,500-$20,572	$35,000-$46,000	0	$15,000
Hurchalla	71,845	30,000- 50,000	7,600	39,680
Thrall	65,476	50,000- 81,000	4,000	80,000

None of the experts who testified at the trial gave a specific projection of the amount of cash-flow Mukerji could expect as "additional rent" during the period of 1987 to 1989 pursuant to the terms of his lease with Comdisco. Each of petitioners' experts, however, indicated that the 3880-1 storage control units owned by Mukerji will continue to have substantial rental value throughout the term of Mukerji's lease with Comdisco.

During the calendar year 1985, the sublessees of the two 3880-1 storage control units owned by Mukerji paid Comdisco $47,016 in rental income. These units were being subleased by Comdisco to two sublessee end-users at the time of trial. The 3340-A2 disk drive owned by Mukerji was not subleased by Comdisco to any sublessee during 1985 and at the time of trial.

The record shows that during the calendar year 1985, the sublessees of the equipment owned by Hurchalla paid Comdisco $22,014 in rental income. All of Hurchalla's equipment was subleased by Comdisco to end-users for part or all of 1985, and at the time of trial, all of Hurchalla's equipment except the 3350-A2 disk drive was on lease to a sublessee end-user.

During the calendar year 1985, the sublessees of the equipment owned by Thrall paid Comdisco $25,440 in rental income. For part or all of 1985, all of the 3350 disk drives owned by Thrall were subleased by Comdisco to end-use and all were similarly subleased at the time of trial. Five the 3277-2 display stations owned by Thrall were sublease by Comdisco to end-users in 1985. The remaining items terminal equipment, which represent 4.3 percent of Thrall purchase price, were not subleased by Comdisco in 1985 at the time of trial.

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[25] As discussed above, the appraisal letters in Hurchalla's and Thrall's transactions were prepared by Richard Forsythe of Forsythe/McArthur Associates, Inc. The appraisal letter in Mukerji's transaction was prepared by Kenneth Steinback of Computer Sales International, Inc.

[26] As discussed above, Withington testified that $20,572 was the more likely projection.

Petitioners' Rebuttal Testimony

Walter Papciak and Richard Paulsen testified for petitio ers as rebuttal witnesses to establish the market conditio of the various equipment at issue.

Walter Papciak (herein Papciak) is a vice president Computer Intelligence Corp. Computer Intelligence Corp. in the business of collecting marketing information concer ing the users of various types of computer equipment. the course of its business, Computer Intelligence Cor conducts surveys to determine the amount of installed IB peripheral equipment throughout the United States. Th information is provided to clients for their use in unde standing the computer market in the United States. addition, Richard Paulsen (herein Paulsen), Comdisco's vi president in charge of data processing services, testifi concerning the records which Comdisco maintains of i equipment on lease.[27] Paulsen produced summaries Comdisco's records which analyzed the amounts of vario items of equipment which Comdisco currently has on leas The testimony of Papciak and Paulsen indicates that di drive devices which Morgan claims are already worthless will soon be worthless are still in demand.

Contrary to Morgan's statement that the 3340 disk driv one of the pieces of equipment purchased by Muker became worthless in 1985, petitioners' rebuttal testimo and exhibits show that thousands of these units were st in use at the time of trial, both by the public and t private sector. As of the date of trial, Comdisco continu to lease these items under noncancelable leases whi extended through 1990.

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[27] Pursuant to sec. 7461(b)(1), petitioners' exhibits numbered 76 through 83 and portions Paulsen's testimony relating to such exhibits have been placed under seal by order of Court due to trade secrets contained therein.

Similarly, the record showed a strong market for 3350 disk drives purchased by Thrall and Hurchalla. Comdisco is currently entering into leases for these units through 1991 and has more 3350 disk drives on lease than new 3380 disk drives. Petitioners also produced evidence from Computer Intelligence Corp. which indicated that among IBM equipment users, the 3350 disk drive continues to remain in use in quantity roughly equal to the new 3380 disk drives. Furthermore, the record shows that both of the 3350-C2 disk drives at issue in this case are currently on lease and are producing income.[28]

ULTIMATE FINDINGS OF FACT

The purchase price in each transaction herein is approximately equal to or below the fair market value of the property. The residual value projection of the equipment as set forth in the respective private placement memorandum is reasonable, and petitioners could reasonably expect a profit.[29]

OPINION

The instant consolidated cases serve as test cases for hundreds of other investors in the programs discussed above.

The principal issue in the instant cases is whether petitioners should be viewed for tax purposes as the owners of the equipment in each respective transaction. Petitioners contend that each of the three transactions at issue involved a significant and realistic possibility of economic profit, and that the form of these transactions therefore must be respected for tax purposes. Respondent claims that the transactions at issue lack economic substance and that the petitioners did not invest in these transactions with the requisite profit motive. Respondent contends that the three

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[28] Thrall owns two 3350-C2 disk drives. These units were being subleased by Comdisco to end-users as of the trial and produced $4,800 of rental income from subleases in 1985.

[29] Neither party has raised or presented the issue as to whether fees or interest should be considered in determining whether petitioners could realize a profit. Nevertheless, we believe that the residual value plus the cash flow to be generated from the transactions by the end of the lease terms is such that petitioners would realize a profit. See *Hilton v. Commissioner*, 74 T.C. 305 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982); compare *James v. Commissioner*, 87 T.C. 905 (1986).

transactions were merely tax-avoidance schemes in whic
petitioners acquired nothing more than a nondepreciab
future interest in the computer equipment.[30] In shor
respondent argues that the transactions herein are sham
entered into solely for the purpose of tax reduction.

Generally, the form of a leasing transaction should b
respected so long as the lessor retains significant an
genuine attributes of a traditional lessor. *Frank Lyon Co.*
United States, 435 U.S. 561, 585 (1978); *Estate of Thoma*
v. Commissioner, 84 T.C. 412, 432 (1985). "We canno
ignore the reality that the tax laws affect the shape
nearly every business." *Frank Lyon Co. v. United State*
supra at 580. Therefore, the existence of tax benefi
accruing to an investor does not necessarily deprive
transaction of economic substance. *Frank Lyon Co.*
United States, *supra* at 581; *Packard v. Commissioner*, 8
T.C. 397, 417 (1985); *Estate of Thomas v. Commissione*
supra at 432. When, however, a transaction has no econom
purpose other than to obtain favorable tax consequence
the form of the transaction will be disregarded by th
Court. *Estate of Thomas v. Commissioner*, *supra*, and th
cases cited therein; *Rice's Toyota World, Inc. v. Commi*
sioner, 81 T.C. 184, 195 (1983), affd. on this issue 752 F.2
89 (4th Cir. 1985); *Grodt & McKay Realty, Inc. v. Commi*
sioner, 77 T.C. 1221, 1243, 1244 (1981). The Supreme Cou
in *Frank Lyon* was presented with a sale-leaseback transa
tion. This Court has also recently decided three case
involving computer equipment leasing transactions. *Rice*
Toyota World, Inc. v. Commissioner, *supra*; *Estate*
Thomas v. Commissioner, *supra*; *Coleman v. Commissione*
87 T.C. 178 (1986). We will briefly discuss the facts an
holdings of each case before turning to the instant case

In *Frank Lyon*, the Supreme Court dealt with th
problem of allocating depreciation deductions in a sal
leaseback transaction and held that the form of th
transaction should be respected. There, Worthen Ban
which was prohibited by State and Federal regulations fro
financing the construction of a new bank building throug

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[30] In the notices of deficiency for two of the cases herein, respondent raised sec. 465 as o
of the grounds for the disallowance of deductions. Respondent chose not to pursue the issue
the application of sec. 465 throughout the trial of these cases and subsequently made
express concession thereof. Accordingly, we need not address that issue here.

conventional methods, sold the bank building to Frank Lyon Co. for a total of $7,640,000, and then leased it back. Frank Lyon Co. put $500,000 down and financed the remaining sum from a third-party lender. The loan was secured by a 25-year mortgage, an assignment of the ground and building lease, Frank Lyon Co.'s promise to assume personal responsibility for the loan's repayment, plus a promise that the building lease would extend through the duration of the 25-year mortgage at a rental amount at least equal to the monthly mortgage payments.

The building lease ran for a primary term of 25 years. During this time, Worthen Bank retained options to repurchase the building at the end of the 11th, 15th, 20th, and 25th year for amounts equal to the then-outstanding mortgage plus Frank Lyon Co.'s initial $500,000 downpayment with 6-percent compounded interest. Alternatively, Worthen Bank could opt to renew the lease for eight additional 5-year terms. Rental payments during the first 25 years were exactly equal to the mortgage payments. This was a net lease, Worthen Bank remaining obligated at all times to maintain the building, to pay all taxes and utility charges, and to buy insurance.

The Commissioner disallowed Frank Lyon Co.'s claimed depreciation and interest deductions and determined that Frank Lyon Co. was not really the owner of the building for tax purposes and the transaction was merely a two-party financing arrangement.

The Supreme Court found that Frank Lyon Co. was indeed the owner of the property for tax purposes. The test in *Frank Lyon* is that in a sale-leaseback context, a nonuser-owner recipient of tax benefits must prove that his entry into the transaction was motivated by a business purpose sufficient to justify the form of the transaction, and that the underlying transaction was supported by economic substance.[31]

In *Rice's Toyota*, we set forth the test whereby a transaction should be disregarded for Federal income tax purposes. Under such test, the Court must find "that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 91, citing *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 209 (1983).

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[31] *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 201-202 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985).

> Once business purpose is established, the transaction should not be classified a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some modicum of economic substance.
>
> Conversely, transactions devoid of economic substance are not always shams such as where a taxpayer mistakenly believes there existed a potential for profit. But when there is a finding that the taxpayer entered into the transaction for tax reasons only, then it is proper to subject the transaction to an objective economic analysis to determine whether there could have been an opportunity for profit.
>
> [81 T.C. at 203 n. 17; citation ommitted.]

To make the determinations of whether a realistic opportunity for economic profit exists to justify the form of the transaction, the Court must probe beneath the labels given by the parties and view the transaction in the context of its surrounding facts and circumstances. *Rice's Toyota World, Inc. v. Commissioner, supra* at 203.

In *Rice's Toyota*, taxpayer purchased computer equipment and leased back such equipment to the seller. The seller then simultaneously subleased such equipment to a third party. The purchase price of $1,455,227 was paid by taxpayer in the form of a promissory note in the amount of $250,000 and two nonrecourse notes. Although an annual cash-flow appeared to be guaranteed, the fine print of the lease revealed that the rent payments were to be satisfied solely out of proceeds of the sublease. The term of the sublease expired 3 years before the expiration of the term of the nonrecourse notes executed by taxpayer.

In *Rice's Toyota*, we first tested the transaction for business purpose and found that there was little, apart from tax considerations, to justify taxpayer's entry into the transaction. We found that taxpayer's president and sole shareholder deviated from his usual practice in investigating the transaction and mainly discussed the tax benefits arising from the transaction. He "made no effort to determine whether [taxpayer] was purchasing an obsolete computer or one that would have a high residual value." 81

T.C. at 202. The only evidence of residual value reviewed by taxpayer's president in *Rice's Toyota* was a Stanford Research Institute report which indicated that taxpayer could not possibly make a profit on its investment. 81 T.C. at 191. Despite the low values predicted in the Stanford Research Institute report, and contrary to its accountant's advice that the residual value of the equipment was important, taxpayer did not seek any independent appraisal of the equipment's residual value. On that evidence, we held that the record showed taxpayer did not evaluate the transaction on an economic basis but was concerned only with tax benefits. Thus, we found that the action of taxpayer in *Rice's Toyota* lacked the requisite subjective business purpose.

In *Rice's Toyota*, after we determined that taxpayer did not enter the transaction therein with a non-tax related business purpose, we tested the transaction for economic substance to determine whether a realistic opportunity for economic profit justified the form of the transaction. Taxpayer's entitlement to only 70 percent of the residual value of the property coupled with the low residual value as established by the most credible projection led us to conclude that taxpayer would not even recover its initial investment. We therefore held that taxpayer would realize no economic value and the transaction had no economic substance.

Estate of Thomas v. Commissioner, 84 T.C. 412 (1985), also involved a computer equipment leasing transaction. In that case, taxpayers who were limited partners in a partnership claimed various deductions in connection with computer equipment leasing activities engaged in by the partnership. The purchase price for the computer equipment was paid with $945,673 of cash and $8,124,561 of nonrecourse debt. We found that the partnership, not the lessee, was the true owner of the computer equipment for tax purposes since taxpayers retained a significant benefit and burden of ownership with respect to the equipment—that the residual value would either generate a profit or a loss. 84 T.C. at 434. Furthermore, we found that the reasonably expected residual value of the equipment was more than sufficient to provide a profit to the taxpayers. 84 T.C. at 433.

In *Estate of Thomas*, we summarized the test set forth in *Rice's Toyota* as one which requires the transaction to either meet the subjective "business purpose" test, or a more objective "economic substance" test and we found that there was economic substance in the transaction. 84 T.C. at 439. The parties there stipulated that the equipment was expected to have a useful life of at least 3 years beyond the lease terms. Furthermore, the parties stipulated that a residual value of 14 percent, which would have enabled the partnership-lessor to recoup its original cash investment and to break even, was reasonably expected. We also found that the record supported a reasonable potential for considerably higher residual values.

In *Estate of Thomas*, we found certain factors to be only neutral in determining the presence of economic substance. We observed that net leases are commonly used and do not necessarily reflect an absence of ownership. 84 T.C. at 433. We held that the absence of significant positive cash-flow during the lease term is a neutral factor. Furthermore, we held that the calculation of rental amount "geared to the cost of interest and mortgage amortization is not, in and of itself, much more than a neutral commercial reality." 84 T.C. at 436. We also held that since nonrecourse liabilities are commonly used in modern transactions, the nonrecourse nature of notes is not necessarily more than a neutral factor. 84 T.C. at 436.

We found the facts in *Estate of Thomas* almost indistinguishable from those of *Frank Lyon Co. v. United States*, 435 U.S. 561, 585 (1978), wherein the investor had made only a 6-percent equity investment in the property involved. In *Estate of Thomas*, taxpayers made a 13-percent equity investment. We held that such substantial equity in the property was indicative of traditional lessor attributes and served to lend substance to the transaction. 84 T.C. at 436. We noted that while the transaction did involve some tax savings in the early years, "its economics" were such that those tax savings would be reduced in later years as the investment encountered a "turn around" after which the investors would be required to pay taxes. As a result, we found that the net tax savings from the investment were considerably less than taxpayer's cash investment which indicated that the transaction was not motivated solely by tax benefits.

In *Coleman v. Commissioner*, 87 T.C. 178 (1986), we found that taxpayer did not have a depreciable interest in property acquired through a chain of transactions. In *Coleman*, taxpayer was a partner in a partnership which acquired an interest in computer equipment from a supplier of computer equipment through several intermediary parties. Such supplier had previously transferred to certain parties (herein lenders) title to computer equipment and arranged for leases of the equipment between the lenders and the supplier's customers. In return therefor, such equipment supplier received an amount based upon the discounted value of the stream of rents receivable under the leases so arranged. The equipment supplier also entered into "residual agreements" with the lenders whereby such supplier would retain options to repurchase the equipment for nominal consideration upon expiration of the leases' initial terms. It was this interest under the residual agreement which the partnership acquired. Upon acquiring the interest in the equipment, the partnership then leased back such interest to its immediate seller.

Respondent argued that the lenders, not the equipment supplier, were the owners of the equipment and, as such, the partnership, as successor in interest to the equipment supplier, had no depreciable interest in the property. Taxpayer in *Coleman* found himself in the unusual position of arguing that the form of the transaction should be disregarded, that the equipment supplier was the owner of the equipment and thus the owner of the depreciable interest.

We found for respondent in *Coleman*. Noting that taxpayers have less freedom than the Commissioner to disavow the form of a transaction, we held that the taxpayer in *Coleman* had the burden of proving *at a minimum* "strong proof" that he had acquired a depreciable interest in the equipment. In *Coleman*, we distinguished *Frank Lyon Co. v United States*, 435 U.S. 561 (1978), and *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985), in at least that regard.

With the foregoing considerations, we now turn to the cases at bar.

Objective Economic Substance

We first address petitioners' argument that the transactions herein involved a significant and realistic possibility of economic profit. To be respected for tax purposes, business transactions must meet a minimum threshold of a business purpose or economic objective. *Rice's Toyota World, Inc. v. Commissioner, supra* at 209. As we discussed above, the inquiry as to economic substance is whether a realistic opportunity for economic profit exists to justify the form of the transaction. *Rice's Toyota World, Inc. v. Commissioner, supra* at 203.

We find that petitioners paid an amount approximately equal to or below fair market value for the equipment. Since respondent's expert produced a higher value for Hurchalla's equipment than the purchase price, the only conflict between the parties on the factor of fair market value is with respect to Thrall's equipment and Mukerji's equipment where respondent's expert testified that the respective purchase prices exceed the fair market values of the equipment. Petitioners' experts and respondent's expert all relied on the Computer Price Guide in arriving at the fair market value of the computer equipment at the time the respective transactions were entered. One difference between the techniques employed by petitioners' experts and those by respondent's expert on the issue of fair market value was the time at which such fair market value should be determined. We find the figures presented by petitioners' experts more credible than those of respondent's expert. In making the calculation of fair market value, Morgan, respondent's expert witness, used the issue of the Computer Price Guide from January of each year. The record shows, however, that such issue of the Computer Price Guide was not available to the public until the beginning of January following each transaction, at the earliest. Therefore, such publication was not available to any of petitioners herein at the time they entered into their respective transactions. Furthermore, Morgan gave her evaluation of fair market values of the equipment as of December 31 of each relevant year, which in each case was a date after the date of each private placement memorandum and a date after each petitioner entered into the transaction and made the initial payment of his investment.

Furthermore, we note that on December 15, 1982, IBM announced a price cut in the 3880-1 storage control unit. Morgan took this price cut into account in determining the equipment's value as of December 31. We find it inappropriate to take into account a price change which took place after Mukerji purchased his equipment in determining the fair market value of Mukerji's equipment at the time he made his purchase.

Petitioners' expert witness, Hartmann, who testified with respect to the fair market value of the equipment here in issue, consulted the October issue (as well as the January issue) of the Computer Price Guide of the respective years. We find that the figures and information as available in the October issue of the Computer Price Guide were those which were available to the public at the time the transactions herein were entered into. Furthermore, we find Hartmann's analysis of a lease premium reasonable. Based on Hartmann's analysis, each petitioner herein purchased the computer equipment for an amount below or approximately equal to the fair market value of the equipment. We are satisfied that at the time of petitioners' entry into the transactions, the purchase price for the equipment at issue was below or approximately equal to its fair market value.

The record demonstrates that with respect to residual values, the forecasting techniques employed by the petitioners' experts were more credible and reasonable than those of respondent's expert, and we find that each petitioner could reasonably realize an economic profit through his investment. First, we note that no business can operate on the basis of hindsight. *Estate of Thomas v. Commissioner, supra* at 428-430. Any business operation involves the risk that a loss, as well as a profit, may result. We therefore analyze the foreseeable residual value of the equipment at the time the transactions were entered into.

We first examine respondent's projections. Morgan, respondent's expert witness, based her residual value testimony on the premise that historically no disk drive ever had an economic life beyond 14 years. Morgan was not an expert in disk drive technology, and she made no technology forecasts during the years at issue. The extent of her exposure to technology was through the news media. Furthermore, petitioners effectively showed that the declining speed of technological change could prolong the economic life of peripheral computer equipment, such as disk drives. In light of her lack of specialized knowledge, we find Morgan's position on the economic life of the residual value disk drives unreliable.

Furthermore, we find respondent's objections to the residual value projection contained in the private placement memoranda and those made by petitioners' expert witnesses of the 3350 disk drive unpersuasive. Morgan claimed the high demand and prices being paid for the 3350 disk drive throughout 1981 were minor aberrations due to the delay in delivery and production of the new 3380 disk drive, a possible replacement for the 3350 disk drive. Yet, all four expert witnesses, including Morgan, agreed that IBM had encountered significant difficulties in producing the new 3380 disk drive throughout this period and these difficulties were not solved until well after Hurchalla and Thral purchased their units. Furthermore, the record indicates that one of the plug-compatible manufacturers had encountered "insurmountable technical problems in developing a 3380" and had not since produced any disk drives as of the time of trial. Therefore, from the record, we do not believe that it was clear in 1980 and 1981 that IBM's significant difficulties in producing the new 3380 disk drive could be easily solved. We also find consumers' willingness to wait as long as 2 years for the delivery of the 3350 disk drive during the 1980-81 period an indication of the market strength of the 3350 disk drive at that time.

We find Morgan's statement that the "intense competition" of the plug-compatible manufacturers was continually forcing down the price of 3350's to be effectively rebutted at trial. We find that the record does not support Morgan's view that the plug-compatible manufacturers were a controlling force in lowering the residual value of the 3350 disk drive. That at the time of trial three of the five plug-compatible manufacturers she mentioned had filed for bankruptcy or withdrawn from the disk drive market casts serious doubt on the strength of plug-compatible manufacturers in the competition with IBM. For these reasons, we find petitioners' expert witnesses' projections more reasonable.

We also find Morgan's view that the 3880 storage control units purchased by Mukerji would be worthless in 1989 not supported by the record. All four of the expert witnesses, including Morgan, agreed that the 3880 storage control unit retains its value in proportion to the disk drives it controls. Therefore, Morgan stated that the 3880 storage control unit would have an economic life as long as that of the 3375 disk drive, which was first installed in 1981. Morgan estimated that the 3375, and therefore the 3880, would be worthless by the end of 1989.[32] However, all the experts agreed that the 3880-1 storage control unit can be upgraded for use with the 3380 disk drive, IBM's latest disk drive, with relative ease and low cost. Furthermore, the experts all agree that upgrading the 3880-1 storage control unit would significantly enhance its residual value and possibly its useful life.

Having found the residual value projections of petitioners' expert witnesses more reliable, we note that the residual value projections in the private placement memoranda are within the range projected by Lyons and, with the exception of the equipment in the Thrall transaction, more conservative than the projections made by Withington. In view of the residual value of the equipment based on the credible projections made by petitioners' experts, the virtually guaranteed cash-flow in the transactions entered into by Thrall and Hurchalla and the high probability of additional rent in Mukerji's transaction, we find there is an opportunity for profit in each of the transactions.

The record shows that petitioners here, like taxpayers in *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985), retained the significant benefits and burdens of ownership with respect to the equipment. Petitioners' initial equity in each transaction exceeded that in the transaction in *Frank Lyon Co. v. United States*, 435 U.S. 561, 585 (1978) (6

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[32] Morgan gave only a vague explanation of why the 3375 would have a useful life of only 8 years while other disk drives usually have useful lives of 14 years.

percent of the purchase price); and *Estate of Thomas* v
Commissioner, supra (13 percent). Mukerji's initial equit
was 16.53 percent of the purchase price of the equipment
Hurchalla's initial equity was 22 percent; and Thrall's initia
equity was 17.75 percent. Furthermore, we find here tha
the residual value of the equipment plus the cash-flov
generated by the rental of the equipment in each transac
tion allows petitioners to at least recoup their initial cas
investment. We also find that like the transaction in *Estat*
of Thomas, the purchase price approximately equals or i
less than the fair market value of the equipment in eac
transaction herein. Finally, petitioners here encounter
"turn around" point in the tax aspects of their transaction
similar to that discussed in our opinion in *Estate o*
Thomas. Although there were initial tax benefits, th
amount of net tax savings in the transactions here i
considerably lower than petitioners' out-of-pocket cash ir
vestments.

We hold that petitioners acquired and retained significan
benefits and burdens of ownership with respect to th
equipment.[33] We also hold that the transactions herein mee
the threshold of economic objective required in *Rice'*
Toyota, that the transactions herein have economic sub
stance, and that therefore they should be respected for ta
purposes.[34]

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[33] We note that due to the burden on taxpayers in *Coleman v. Commissioner*, 87 T.C. 17
(1986), to present "strong proof," the instant case is distinguishable therefrom. Furthermor
in *Coleman*, although we held that identity of lease payments and debt payments under th
nonrecourse notes in effect canceled each other and should be ignored in determining th
nature of the interest in the property acquired by the taxpayers, we emphasized that recour
financing presents a different case. Since the debt financing herein is recourse to the extent
68 to 100 percent, and there was almost complete certainty that the nonrecourse portio
would be repaid, we find *Coleman* also distinguishable in this respect.

[34] Furthermore, we note that in *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 18
(1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985), we stated that a genuine indebtedne
supported by an actual investment is strong evidence of economic substance. 81 T.C. at 20
Since we find that the notes executed in the transactions herein are recourse to the extent
68 to 100 percent with substantial certainty of repayment with respect to the min
nonrecourse portion, the purchase price approximately equals or is less than the fair mark
value of the equipment in every transaction, and the residual value plus the cash-flow to b
generated from the rental of the equipment is sufficient for petitioners to realize a profit, the
exists in these transactions a genuine indebtedness supported by an actual investment. S
Knetsch v. United States, 364 U.S. 361 (1960); *Estate of Franklin v. Commissioner*, 544 F.2
1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975); *Rice's Toyota World, Inc. v. Commissioner*,
T.C. 184 (1983); *Narver v. Commissioner*, 75 T.C. 53 (1980), affd. per curiam 670 F.2d 855 (9
Cir. 1982).

In addition to the foregoing, we also note that petitioners entered into the transactio
herein for a business purpose and not solely for tax reasons. At trial, the Court was impress

Additions to Tax and the Application of Section 6621(d)

We now address the issues of whether certain petitioners are liable for additions to tax pursuant to sections 6653(a)(1), 6653(a)(2), or 6659. Section 6653(a) in 1980 and section 6653(a)(1) in 1981 and 1982 provide for an addition to tax of 5 percent of any underpayment that is due to negligence or intentional disregard of rules and regulations. Section 6653(a)(2) in 1981 and 1982 provides for an addition to tax in an amount equal to 50 percent of the interest payable under section 6601 with respect to the portion of the underpayment due to negligence or intentional disregard of rules and regulations. Section 6659 provides for an addition to tax in an amount equal to a certain percentage of the underpayment attributable to a valuation overstatement. Sections 6653(a)(1), 6653(a)(2), and 6659 apply where there is an underpayment as defined in section 6653(c). Since we find herein that the transactions have economic substance and should be respected, there is no underpayment within the meaning of section 6653(c), and we hold therefore that petitioners are not liable for additions to tax under sections 6653(a)(1), 6653(a)(2), or 6659 with respect to the transactions at issue herein.[35]

Respondent raised in his amendment to answer the applicability of section 6621(d). Section 6621(d) provides that, in the event an underpayment exceeds $1,000 and is attributable to tax motivated transactions, the interest payable on such underpayment is 120 percent of the rate

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by petitioners' credible testimony, and we are convinced that petitioners are prudent by petitioners' credible testimony, and we are convinced that petitioners are prudent businessmen who entered into investments which they believed present a potential for profit. The record establishes that petitioners consistently scrutinized each investment they entered into with great care. We find that they followed this practice in entering into the transactions here.

[35] We do not decide here the application of secs. 6653(a)(1), 6653(a)(2), and 6659 with respect to the severed issue in docket No. 34124-84 involving petitioners Aditya B. Mukerji and Swati Mukerji. Furthermore, in docket No. 39312-84, petitioners Charles F. Hurchalla and Judith Hurchalla had conceded the remaining Federal income tax adjustments raised by respondent in the notice of deficiency and had failed to introduce evidence to overcome respondent's determination of negligence under sec. 6653(a)(1) for 1980 and sec. 6653(a)(1) for 1981 with respect to such conceded items. Rule 142. We therefore sustain the addition to tax under sec. 6653(a)(1) with respect to the amount of deficiency attributable to the conceded items. Rule 149. Respondent also determined an addition to tax under sec. 6653(a)(2) for 1981 with respect to an issue which was conceded by petitioners Charles F. and Judith Hurchalla. As petitioners introduced no evidence in that regard, they have failed to carry their burden of proof, and we accordingly sustain respondent's determination of additions to tax under sec. 6653(a)(2) with respect to such conceded item. Rules 142, 149.

established under section 6621(b). In light of our findings herein, we hold there is no underpayment which is attributable to tax motivated transactions and that section 6621(d) does not apply with respect to the transactions at issue herein.

To reflect the foregoing,

Decisions will be entered under Rule 155.

Reviewed by the Court.

STERRETT, GOFFE, CHABOT, NIMS, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, CLAPP, SWIFT, JACOBS, GERBER, and PARR, *JJ.*, agree with this opinion.

PARKER, COHEN, WRIGHT, and WILLIAMS, *JJ.*, agree with the result only.

SIMPSON and WELLS, *JJ.*, did not participate in the consideration of this opinion.

LAURENCE R. AND MARGARET E. ZIRKER, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16762-85. Filed October 30, 1986.

P's claimed Schedule F losses on their 1981 and 1982 Federal income tax returns from an investment in dairy cattle. The losses were comprised of investment credit and depreciation deductions as well as other claimed operating expenses. R disallowed the claimed losses. *Held*: That no sale of the cattle occurred for tax purposes. Accordingly, P's are not entitled to the claimed losses. *Held, further*, that a valuation overstatement exists within the meaning of sec. 6659, I.R.C. 1954, since petitioners reported an adjusted basis in the cattle of $41,500 and the correct adjusted basis in the cattle is zero. *Held, further*, that the portion of the underpayment resulting from the disallowed depreciation deductions and disallowed investment credit is attributable to the valuation overstatement. *Held, further*, P's are liable for additional interest under sec. 6621(d) with respect to the portion of the underpayment attributable to the valuation overstatement under sec. 6621(d)(3)(A)(i).

Rex C. Bush, for the petitioners.

James B. Ausenbaugh, for the respondent.

WHITAKER, *Judge*: This case was assigned to and heard by Special Trial Judge Peter J. Panuthos pursuant to the provisions of section 7456 of the Code and Rules 180 and 181.[1] The Court agrees with and adopts the Special Trial Judge's opinion, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

PANUTHOS, *Special Trial Judge*: Respondent determined the following deficiencies in petitioners' Federal income tax:

Year	*Deficiency*
1981	[2]$9,412
1982	5,915

In his notice of deficiency respondent disallowed claimed losses incurred by petitioners resulting from an investment in dairy cattle. Respondent also disallowed an investment credit claimed for 1981. By his answer respondent seeks additions to tax under section 6659 for valuation overstatements and further seeks additional interest under section 6621(d) on the grounds that the underpayments for 1981 and 1982 are attributable to a tax motivated transaction.[3]

The issues for decision are whether petitioners are entitled to the claimed loss in connection with their investment in Holstein dairy cattle and whether petitioners are subject to the additions to tax under section 6659 and to additional interest under section 6621(d).

FINDINGS OF FACT

At the time they filed their petition, petitioners resided in Columbus, Ohio. Some of the facts have been stipulated and are incorporated herein by this reference.

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[1] All section references are to the Internal Revenue Code of 1954 in effect during the taxable years in question unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

[2] By Order dated June 13, 1986, the small tax case designation was removed since it became apparent that the amount of deficiency in dispute for 1981 exceeded $10,000 upon consideration of respondent's claim for additions under sec. 6659 (see note 3 *infra*). Sec. 7463(e); Rules 171 and 173.

[3] Since the petition in this case was filed under the small tax case procedure, no answer was filed in response to the petition. Rule 175(b). Counsel for petitioners did not object to respondent's motion for leave to file an answer making a claim for the addition to tax under sec. 6659 and increased interest under sec. 6621(d). Respondent's answer was filed on Feb. 14, 1986.

During 1981, petitioner Larry Zirker (petitioner) worked as a welder.

Roy Tolson (Tolson), promoter of the investment and owner of Financial Futures, contacted petitioner and encouraged petitioner to invest in cattle. Petitioner had known Tolson for many years, and it was through Tolson that petitioner had previously invested in cattle in 1980. Tolson provided petitioner with a prospectus of expected income and expenses. According to the prospectus, petitioner could expect a return on his investment of $119,437 in 1981, and $126,795 in 1982. Tolson presented the investment as a cattle breeding program; however, the cows were also to be milked and the milk sold for profit.

Before investing in the cattle, petitioner consulted with his friend Wayne Asay, a county extension agent in Wyoming. (A county extension agent is a governmental adviser to those involved in agricultural activity in the county.) Asay had no particular expertise in cattle or dairy farming. Nevertheless, Asay agreed that the cattle in which petitioner was interested were Holstein pedigrees and opined that they would be a good investment.

On June 24, 1981, petitioner entered into a purchase agreement whereby he agreed to purchase five registered Holstein dairy cattle. According to schedule A attached to the agreement, the total purchase price of the five cattle was $41,500.[4] It is not clear from the record what the purchase price of each separate animal was. The terms of the purchase were $2,500 in cash down; $2,500 due on a promissory note to be paid on closing; a second promissory note for $18,056; and a third promissory note for $18,444. The terms of the promissory note for $18,056 required payment in seven annual installments of $3,956. The promissory note for $18,444 required petitioner to pay that amount on January 1, 1988, together with interest at the rate of 9 percent per year on the unpaid principal.

The three notes given on June 24, 1981, were secured by cattle in the herd and were nonrecourse notes. In late 1981, Tolson sent petitioner new agreements to sign which altered the security on the notes. Petitioner signed notes which indicated that he was personally liable for their repayment. These notes were dated June 24, 1981, although they were sent to petitioner in November 1981. The notes purported to change petitioner's liability from nonrecourse to recourse. Petitioner received no consideration from Tolson in exchange for petitioner's promise to be personally liable on the notes.

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[4] At trial the parties stipulated that the cash value of the five cattle on June 24, 1981, totaled $9,600. The parties further stipulated that if the cattle were sold on credit, they would have been worth one-third to one-half more.

The original purchase agreement also contained a covenant by petitioner that he had a net worth in excess of $100,000 (exclusive of home, automobile, and furnishings) and that some portion of his 1981 income would be subject to a Federal or State tax of 50 percent. In addition, the original purchase agreement contained a clause in which petitioner acknowledged that anticipated tax benefits may not be realized as a result of changes in Federal tax laws.

According to the terms of the original purchase agreement and the schedule attached to it, petitioner could not sell, remove, destroy, or otherwise handle any cow without Tolson's written permission. Tolson and petitioner also entered into a management agreement whereby Tolson agreed to be responsible for management of the animals. Petitioner could not and did not operate or supervise the dairy, nor did he make any decisions affecting the cattle's breeding. Petitioner was never consulted on whether to artificially inseminate, which sire would be chosen, or which cattle would be bred. He never asked to exercise any control over these matters and had no say as to which cows would be sold, culled, or left in the breeding stock.

Petitioner spent only a minimal amount of time at the dairy. In the fall of 1984 he spent a few days building a fence at the dairy. Petitioner called Tolson from time to time to inquire about his investment.

Petitioners' gross receipts, total deductions and net farm loss as claimed on a Schedule F for 1981 and 1982 are as follows:

Item	*1981*	*1982*
Gross receipts	$14,607	$16,478
Total deductions	36,155	39,620
Net farm loss claimed	(21,548)	(23,142)

The specific Schedule F deductions claimed are as follows:

Claimed farm deductions	*1981*	*1982*
Labor Hired	$1,994	$2,819
Repairs, maintenance	159	247
Interest	5,943	7,130
Rent of farm, pasture	1,989	2,820
Feed purchased	8,846	7,914
Supplies purchased	481	972
Breeding fees	288	544
Veterinary fees, medicine	322	334
Gasoline, fuel, oil	---	101
Storage, warehousing	5	---
Taxes	110	437
Insurance	366	218
Utilities	449	579
Freight, trucking	466	161
Transportation	640	240
Advertising	140	63
DHIA	557	214
Registration	---	60
Subtotal	22,755	24,853
Depreciation[5]	13,400	14,767
Total Deductions	36,155	39,620

Petitioners also claimed an investment credit for the taxable year 1981 in the amount of $3,037 reporting an adjusted basis in the cattle of $41,500.

In his notice of deficiency dated April 15, 1985, respondent disallowed the claimed farm losses in full. As a basis for disallowance, respondent's notice stated as follows:

> (a) The Schedule F. losses claimed by you in 1981 and 1982, in connection with 'Financial Futures', are disallowed in full because you have not established, in support of your claimed losses, that you acquired any equitable, legal or other interest in dairy cattle. The Schedule F losses reported by you are disallowed in full because none of the losses have been verified, substantiated or demonstrated to be properly reportable and allowable under any provision of the Internal Revenue Code of 1954. Additionally, the losses are disallowed for the reason that you have not established that:
>
> (1) You were engaged in, or held the property for use in a trade or business or for production of income;
>
> (2) The transaction whereby you purportedly acquired the property had economic substance or purpose other than avoidance of tax;

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[5] For purposes of depreciation the "cost or basis" was reported in the amount of $41,500.

> (3) you acquired a depreciable interest in the property in 1981;
>
> (4) the property was placed in service in 1981;
>
> (5) that any expenses claimed on your 1981 and 1982 tax returns, in connection with Financial Futures were paid or incurred; and
>
> (6) that amount, if in fact paid or incurred, was an ordinary and necessary expense or was paid for the purpose claimed.
>
> Furthermore, you have not established your basis, if any, in the property. In any event, your basis may not include unpaid portions of the nonrecourse financing which lacks economic substance and does not constitute a bonafide loan. Any losses with respect to the property are limited to the amount at risk as defined by the Internal Revenue Code of 1954. Neither have you established that any expenses, if paid or incurred, were not capital expenditures and, therefore, not currently deductible. Accordingly, your taxable income for 1981 and 1982 is increased $21,548 and $23,142, respectively. Additionally, your tax liability for 1981 is increased $3,037, the amount of Investment tax credit claimed with respect to the dairy cattle, which is being disallowed for the reasons stated above.

OPINION

We must decide whether petitioner is entitled to the claimed loss and investment credit in connection with his investment in Holstein dairy cattle.

In support of his position, respondent relies on *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975).[6]

Petitioner bears the burden of proof. *Welch v. Helvering*, 290 U.S. 111 (1933). Petitioner maintains that his investment in cattle was a profit motivated investment spurred by his desire to leave the welding profession and lead an easier lifestyle. Therefore, he argues that he is entitled to the deductions claimed in connection with the dairy cattle. For the reasons set forth below, we find for respondent.

Our initial inquiry is whether a sale of the five Holstein cows ever occurred. It is axiomatic that the economic substance of a transaction governs over its form. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Estate of Franklin v. Commissioner*, *supra*. A sale generally occurs for tax purposes when there is a transfer of property for money or a promise to pay money. *Commissioner v. Brown*, 380 U.S.

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[6] In support of his theory that petitioners never acquired an interest in the cattle or a genuine indebtedness to purchase the cattle, respondent cites *Ramirez v. Commissioner*, T.C. Memo. 1982-608; *Hunter v. Commissioner*, T.C. Memo. 1982-126.

563, 570-571 (1965). As we have stated previously, the key to determining whether a sale occurred in factual situations like the one presented here depends on whether the benefits and burdens of ownership passed from the purported seller of the cattle to the taxpayer. See, e.g., *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981). This determination is a factual one based on all of the facts and circumstances. *Leahy v. Commissioner*, 87 T.C. 56 (1986); *Derr v. Commissioner*, 77 T.C. 708 (1981); *Grodt & McKay Realty, Inc. v. Commissioner, supra*; *Haggard v. Commissioner*, 24 T.C. 1124, 1129 (1955), affd. 241 F.2d 288 (9th Cir. 1956).

There are several factors to be considered in determining whether what is purported to be a sale in form is also a sale in economic substance.[7] The first is to consider whether the stated price for the property is within a reasonable range of its value. According to the purchase agreement, petitioner was to pay Tolson $41,500 for five cows which petitioner now agrees were worth $9,600. The sales price of the cattle (if purchased for cash) was over four times the fair market value, and their sales price (if purchased on credit) was nearly three times the fair market value.[8]

The next factor to consider is whether the purported purchaser had any control over the property and, if so, to what extent. As we have already found, petitioner could not determine what cows would be inseminated or culled; he could not remove or sell any of the cattle without Tolson's written permission; and he did not know the actual extent of his control over the cattle.

Petitioner could not choose to house and care for the cattle at a facility of which Tolson did not approve. Tolson actually retained control of the cattle. Indeed, the registration certificates of the cows reflect Trydale Dairies as owner of the cattle. Tolson originally bought the cattle from Trydale Dairies.

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[7] See *Hunter v. Commissioner, supra.*

[8] Petitioner stipulated that the actual fair market value of the cattle was $9,600 or one-half to one-third more if purchased on credit. Utilizing the figure most favorable to petitioner we take one-half of $9,600 or $4,800 and add the two figures together to arrive at $14,400. This amount is the maximum stipulated value of the cattle if purchased on credit. Yet on their Federal income tax returns for 1981 and 1982, petitioners reported the basis of the cows for purposes of depreciation to be $41,500.

Next, we must determine whether there was any intent that the stated purchase price of property would ever be paid. Petitioner's evidence on this point is insufficient to prove either the intention to pay, or the actual payment of, the full purchase price required by the agreement. Petitioner provided some services to the dairy in 1984 by helping to build a fence. Nevertheless, petitioner has not established the value of his services, nor can we make any finding regarding the value based on the record. As to any other amounts, petitioner offered no credible evidence that he had actually made yearly payments. No canceled checks or contemporaneous documentation was offered. The only evidence submitted to substantiate payment was a list from Tolson itemizing the payments.[9] Based on the entire record, we find that petitioner paid $2,500 on June 24, 1981 and an additional $2,500 in 1982.

Moreover, petitioner claims to be personally liable on the notes given to Tolson. In late 1981, Tolson wrote petitioner and asked him to sign a new set of promissory notes. Tolson explained that because of changes in the law under the Economic Recovery Tax Act of 1981, in order to preserve any anticipated tax benefits, petitioner had to re-sign the notes which were backdated to June 24, 1981. The record does not support the conclusion that petitioners would have or could have been called upon to pay the notes personally. These backdated notes which purport to change the character of petitioner's liability from nonrecourse to recourse are merely illusory and have no effect.

Finally, the last criterion is whether the purchaser will receive any benefit from the disposition of the property. Looking at petitioner's involvement in the investment, it is clear that petitioner did not have a profit objective. Despite his assertion that his investment was intended to secure his financial future, petitioner never inquired of Tolson when the investment would become profitable.

We are satisfied that this transaction was not a sale for Federal tax purposes. The transaction was so lacking in economic substance that it should not be recognized.

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[9] Tolson furnished petitioner a list of payments specifically for purposes of the trial. A payment list prepared by the promoter a week before trial is hardly adequate to prove payment. Despite the fact that respondent did not object to the admission of this document, we need not rely on it. We accord little weight to this evidence.

Petitioner entered into the transaction in an attempt to obtain tax benefits. Accordingly, respondent's determination is sustained and the claimed losses are disallowed.[10] *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237, 1243 (1981).[11]

Section 6659

Respondent made claim in his answer for a valuation overstatement pursuant to section 6659. The burden of proof is on respondent since such claim was not included in the notice of deficiency and, therefore, is a new issue seeking an increased deficiency. Sec. 6214(a); Rule 142(a).

Section 6659 provides for an addition to tax if a taxpayer has an underpayment of tax which is attributable to a valuation overstatement. The addition to tax is an amount "equal to the applicable percentage of the underpayment so attributable." Sec. 6659(a). Section 6659(c) defines a valuation overstatement as follows:

> (c) VALUATION OVERSTATEMENT DEFINED.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

The applicable percentage is set forth in section 6659(b) as follows:

> (b) APPLICABLE PERCENTAGE DEFINED.—For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct valuation—	The applicable percentage is:
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent. . .	20
More than 250 percent	30

The adjusted basis of the cattle claimed on the return was $41,500. We have found that no sale occurred. Since no sale occurred and title did not pass it follows that petitioner's "correct" adjusted basis in the cattle is zero. *Grodt &*

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[10] We note that the notice of deficiency disallows the Schedule F losses and not all claimed deductions. Since there was income reported for both of the years in issue and respondent disallowed claimed losses rather than all claimed deductions, the effect of sustaining respondent's determination is to allow some of the claimed deductions in an amount which is equal to the income reported. (See schedule at pp. 973 and 974 of this opinion.)

[11] See also *Hunter v. Commissioner*, T.C. Memo. 1982-126.

McKay Realty, Inc. v. Commissioner, supra.[12] Thus, there is a valuation overstatement since the adjusted basis claimed on the return exceeds the correct adjusted basis by at least 150 percent. Sec. 6659(c). Since the valuation overstatement exceeds 250 percent, the applicable percentage is 30 percent.

Having determined that there is a valuation overstatement, we must next determine whether the entire underpayment is attributable to the valuation overstatment or, if not, what portion of the underpayment is attributable thereto. In order to make this determination we are required to examine how the valuation overstatement affects the disallowed loss. Since the loss is comprised of various deductions, we look first to those deductions which are directly affected by the determination of the valuation overstatement.

The result of a finding of a zero adjusted basis causes a disallowance of the depreciation deduction for both years in issue as well as a disallowance of the investment credit claimed for 1981. The allowance of depreciation and investment credit are both dependent on a taxpayer establishing a basis in property. Secs. 38(c)(1) and 48(c)(3)(B) (investment credit) and secs. 167(g), 1011(a) and 1012 (depreciation); see also *Zuanich v. Commissioner*, 77 T.C. 428 (1981). Thus, to the extent the underpayment is due to the disallowed depreciation deductions and disallowed investment credit, the underpayment is "attributable to" a valuation overstatement and subject to the addition imposed by section 6659. Since the depreciation deductions for each year and the investment credit for 1981 are of a lesser amount than the total claimed loss for each year, we must decide whether any other portion of the disallowed loss (creating the underpayment) is "attributable to" a valuation overstatement.[13]

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[12] The nonrecourse debt which unreasonably exceeds the value of the cattle is not considered a valid debt and, accordingly, does not constitute an investment in the cattle. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) affg. 64 T.C. 752 (1975); *Waddell v. Commissioner*, 86 T.C. 848, 898-903 (1986); *Noonan v. Commissioner*, T.C. Memo. 1986-449.

[13] The net farm losses claimed were $21,548 and $23,142 for 1981 and 1982, respectively. The depreciation claimed was $13,400 and $14,767 for those years, respectively. The investment credit claimed for 1981 was $3,037. The remaining expenses deducted by petitioners on their Schedule F, which comprise the claimed losses, relate to operating expenses as well as interest, insurance, and other items. (See pp. and of this opinion *supra*.)

The reporting of an adjusted basis in the cattle of $41,500 and our finding of a correct adjusted basis of zero does not directly affect the remaining deductions for operating expenses claimed under section 162(a) and section 1.162-12(a), Income Tax Regs. The interest deduction claimed under section 163 likewise is not directly affected by a finding of a zero adjusted basis. These expenses have been disallowed because of our finding that for tax purposes no sal occurred and, therefore, petitioners did not own the cattle o operate a cattle farm. The interest expense is not deductibl since no valid debt existed.[14] In addition, petitioners did not offer any evidence that they paid the claimed expenses.

Accordingly, we look to determine whether these claime deductions are affected by the finding of a valuatio overstatement in some other way. In this regard we not that one of the ingredients in our finding that the transaction was not a sale for tax purposes was that the stipulate fair market value of the cattle was substantially less tha the adjusted basis reported on the return.[15] However, we d not view this as a valuation overstatement as defined i section 6659(c) for purposes of this case. Section 6659(c provides that there is a valuation overstatement if (1) th value of any property, *or* (2) the adjusted basis of an property, *claimed on any return* is 150 percent or more o the correct amount. In this case, petitioners claimed a adjusted basis in the cattle on their return for purposes o depreciation and investment credit. Thus, we cannot sa that petitioners *claimed* a *value* on their *return* which w could use as a benchmark with which to compare th stipulated (correct) fair market value. See *Nielsen v. Commissioner*, 87 T.C. 779 (1986).

Since the only valuation overstatement in this case i based on our finding that the correct adjusted basis in th property was zero, rather than $41,500 as claimed on th return, which finding resulted from our conclusion that n sale occurred, it follows that the valuation overstatement i not an ingredient of, but rather the result of the findin that no sale occurred. Accordingly, the remaining disallowe deductions (creating an underpayment) which result fron the finding that no sale occurred are not attributable to a valuation overstatement.

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[14] See note 12 *supra*.

[15] See note 8 *supra*.

Section 6621(d)

As discussed previously, with respect to section 6659, the applicability of section 6621(d) was first raised by respondent in his answer and thus the burden of proof is on respondent. Sec. 6214(a); Rule 142(a).

In his answer, respondent makes a claim for additional interest as follows:

> 7(e). Because of the valuation overstatement, the depreciation claimed on petitioners 1981 and 1982 Federal income tax returns are tax motivated transactions under the provisions of I.R.C. section 6621(d)(3)(i).

Section 6621(d) provides for an increase in the interest rate in respect of interest payable under section 6601 where there is a "substantial underpayment" (an underpayment of at least $1,000) "attributable to one or more tax motivated transactions." The additional interest accrues after December 31, 1984, even though the transaction was entered into prior to the enactment of section 6621(d). *Solowiejczyk v. Commissioner*, 85 T.C. 552 (1985), affd. without published opinion 795 F.2d 1005 (2d Cir. 1986). A tax-motivated transaction includes "any valuation overstatement (within the meaning of section 6659(c))." Sec. 6621(d)(3)(A)(i). *Stanley Works and Subsidiaries v. Commissioner*, 87 T.C. 389 (1986); *Johnson v. Commissioner*, 85 T.C. 469, 482 (1985); *Law v. Commissioner*, 84 T.C. 985, 989 (1985).[16]

Based on our finding that section 6659 is applicable, there is no doubt that section 6621(d) should also be applied. Sec. 6621(d)(3)(A)(i). Accordingly, the portion of the underpayment attributable to a valuation overstatement is subject to additional interest under section 6621(d).

Section 6621(d)(3)(A)(i) through (iv) sets forth circumstances other than a valuation overstatement as a tax-motivated transaction.[17] A question arises under the facts of this case whether any portion of the underpayment of tax that is not attributable to the valuation overstatement is otherwise attributable to a tax-motivated transaction. In his claim, respondent specifically limits his allegations to the extent that the addition to tax under section 6621(d) is based on a valuation overstatement under section 6659. Respondent does not make a general claim under sec. 6621(d) that the additional interest should be applied on the premise that some portion of the underpayment was due to a tax-motivated transaction (other than a valuation overstatement).[18] Accordingly, we need not decide in this case whether any additional interest under section 6621(d) applies to any portion of the underpayment not attributable to the valuation overstatement since respondent has not made claim for it.[19] Sec. 6214(a); Rule 142(a); *Estate of Falese v. Commissioner*, 58 T.C. 895, 899 (1972).[20]

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[16] See also *Hunter v. Commissioner*, T.C. Memo 1986-308; *Schachter v. Commissioner*, T.C. Memo 1986-292.

[17] See Temporary Regulations adopted Dec. 26, 1984. Sec. 301.6621-2T, [A-4], Proced. & Admin. Regs., T.D. 7998, 1985-1 C.B. 368, 49 Fed. Reg. 50390 (Dec. 28, 1984); see *Harmon v. Commissioner*, T.C. Memo. 1986-305; *DeMartino v. Commissioner*, T.C. Memo. 1986-263; *Forseth v. Commissioner*, T.C. Memo. 1985-279.

In order that the parties may compute the amount of the addition to tax under section 6659 and the additional interest under section 6621(d),

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, GERBER, WRIGHT, PARR, and WILLIAMS, *JJ.*, agree with this opinion.

WELLS, *J.*, did not participate in the consideration of this case.

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[18] Respondent's allegations in his answer are even restrictive within the context of sec. 6659. Respondent refers only to depreciation and not to investment credit as a basis for application of sec. 6621(d)(3)(i).

[19] We note that this section has been amended by provisions of sec. 1535, Tax Reform Act of 1986, Pub. L. 99-514, sec. 1535, 100 Stat. 2750, to include within its scope "(v) any sham or fraudulent transaction." The possible application of this amendment has not been suggested by respondent. Under the circumstances of this case, we need not resolve a question which has not been raised by one of the parties.

[20] *Long v. Commissioner*, T.C. Memo. 1982-170; *Harris v. Commissioner*, T.C. Memo. 1969-49.

JAMES HELBA, JR., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 8218-83, 21648-84. Filed October 30, 1986.

Petitioner was the general partner in four partnerships which purchased videotaped productions. Each of the partnerships paid approximately $2.3 million for a production. In each case, more than $2 million of the purchase price was paid with a note guaranteed on a pro rata basis by the limited partners. The notes were initially fully recourse, but could convert to nonrecourse on the occurrence of certain contingencies. Each of the videotapes was purchased from a corporation which was either directly or indirectly controlled by Lawrence Scheer. Scheer effectively controlled all aspects of the transactions, while petitioner's primary activity involved obtaining investors for the partnerships. *Held*, the purchase transactions here in issue were in substance shams lacking economic significance beyond expected tax benefits. *Falsetti v. Commissioner*, 85 T.C. 332 (1985). *Held, further*, petitioner is liable for additional interest pursuant to sec. 6621(d), I.R.C. 1954, with respect to the amount of the underpayments attributable to basis claimed in the property in issue because such underpayments are attributable to tax-motivated transactions. Secs. 6621(d)(3)(A)(i), 6659(c), I.R.C. 1954.

Kenneth M. Barish, *Henry W. Walther*, and *John D. Humbert* for the petitioner.

Marshall W. Taylor and *Phoebe L. Tang*, for the respondent.

NIMS, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes:

Year	*Deficiency*
1979	$40,701.00
1980	54,942.12
1981	35,482.90

The issues for decision are:

(1) Whether the transactions between the partnerships, executive producers, and producers were tax shams lacking economic substance;

(2) Whether the activities of the partnerships with respect to the purchase and distribution of the videotapes consti-

tute activities engaged in for profit within the meaning o section 183;[1]

(3)Whether the partnerships may include in their basis i the videotapes the amounts represented by convertibl notes;

(4) Whether petitioner's basis in his partnership interest includes amounts attributable to services rendered o amounts paid with a promissory note;

(5) Whether petitioner's amount at risk includes his pro rata portion of the partnerships' liabilities represented by the convertible notes;

(6) Whether the partnerships used a proper method o depreciation for the videotapes;

(7) Whether the partnerships are entitled to deduct organizational costs, management fees, legal fees, commissions, and interest in the years in which they were incurred or paid;

(8) Whether petitioner is entitled to claim investment tax credits with respect to the videotapes; and

(9) Whether petitioner substantially underpaid tax in the years in issue as a result of a tax-motivated transaction within the meaning of section 6621(d).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Background

Petitioner resided in Pittsburgh, Pennsylvania, at the time the petitions were filed in this case.

Petitioner is a certified financial planner and was a general partner in each of the four limited partnerships which are the subject matter of this case. The four partnerships are Children's Fantasy, Ltd. (CFL), Geppetto's Music Shop (GMS), Merry Wives, Ltd. (MWL), and Macbeth, Ltd. (MBL) (collectively referred to as the partnerships).

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner also held an interest as a limited partner in MWL. Each of the partnerships elected to use the accrual method of accounting.

As a certified financial planner, petitioner evaluated investment alternatives and advised clients on choosing investments. In the fall of 1978, petitioner attended a 4-day convention of the International Association of Financial Planners where, among other investment opportunities, firms were marketing videotape programs. Prior to this, petitioner had no knowledge or background in videotapes, movies, films, the home entertainment industry, or product distribution, other than being involved with the distribution of one film in 1976. Petitioner contacted only a few sellers of videotape investments, but he did receive a great deal of literature on such investments.

Knowing of petitioner's interest in videotape products, a colleague of petitioner's suggested that he contact Century Video Corp. (Century). Petitioner contacted Lawrence Scheer at Century in November 1978. Scheer had formed Century in 1977, to act as an executive producer of television products. Scheer had first begun researching television production and the home video market in 1976. Prior to this, he had a 25-year career in the life insurance business. Leonard Francouer was the president and a director of Century.

Between 1977 and 1980, Century marketed single shows to individuals by use of an investment vehicle referred to as "one-on-ones." Century contracted with Solaris International Pictures, Inc. (Solaris), to produce these shows. Century generally sold the one-on-ones to individual investors for a fixed price of $100,000, usually consisting of $10,000 cash and a promissory note in the amount of $90,000. Century would pay Solaris $6,000 to $7,000 in cash and execute a promissory note for $60,000 to $65,000 for the production. The notes executed by the investors were initially fully recourse with respect to the investors, but upon the occurrence of certain contingencies could convert to nonrecourse.

Solaris was a company through which Glenn Taylor produced television programs.[2] Through at least 1979, Glenn Taylor did not own any of Solaris' stock, but at some undetermined date he acquired an option on Solaris' stock by guaranteeing approximately $1 million of the company's debt. He later gained control of Solaris by exercising this option. Glenn Taylor had previously produced television programs through a wholly owned company, Syntar Productions (Syntar), but when Solaris was formed it took over the use of Syntar's production facilities. From 1975 to 1977, Syntar's productions were predominantly one-half hour shows which were financed by use of one-on-one investments. During 1976 and 1977, approximately 100 to 110 individuals purchased videotape productions from Syntar.

Prior to 1979, Century sold approximately 120 Solaris one-on-ones to 80 individuals. Starting in early 1979, petitioner recommended the purchase of videotapes marketed by Century to his financial planning clients. Approximately 20 of petitioner's clients invested in the one-on-ones, for which petitioner received client fees and sales commissions. None of these one-on-ones have returned any income to their individual investors.

Production and Financing Structure

In 1977, Scheer met with Jacob Brandzel, a tax partner in the accounting firm of Laventhol & Horwath, and Shelley Banoff, a tax attorney in the Chicago law firm of Katten, Muchin, Gitles, Zavis, Pearl & Galler, to discuss changes in the tax laws and development of a financing structure for producing videotapes based on a partnership format. The financing structure developed by Scheer, Brandzel, and Banoff was used as the basis for the partnerships in this case. The plan required the partnerships to enter into a contract to purchase a videotaped production from an executive producer in exchange for cash and a note. Investor/limited partners contributed cash to the partnership and executed assumption agreements which made them personally liable for a pro rata portion of the note executed by the partnership. The liability of the limited partners pursuant to the assumption agreements, however, could terminate upon the occurrence of certain contingencies.

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[2] The role of a production company such as Solaris or Syntar is to create the production. This includes writing the production and providing a producer, creative staff, and talent.

The executive producer was to acquire the videotaped production by entering into a production order subcontract with a producer. This contract would allow the executive producer to pay for the production by use of cash and deferred obligations. The producer, in turn, would hire talent to work on the production by paying them minimum cash payments and deferred obligations.

Debt Structure

Banoff and Brandzel also developed the form of the notes executed by the partnerships and the assumption agreements executed by the investor/limited partners. The outstanding principal on each note, along with any accrued but unpaid interest, was due on February 1 of the eighth year following the year in which they were executed. The notes bore interest at an annual rate of 9 percent, but interest in excess of $52,000 per year could be accrued and added to principal. The partnerships were required to use 80 percent of the gross receipts from distribution to pay principal and interest on the notes in each year.

The liability of the investor/limited partners under the assumption agreements could terminate, and the notes become nonrecourse, upon the occurrence of either of two contingencies. Their liability terminated if, at anytime during the term of the note, the partnership made payments on the note (interest and/or principal) totaling at least one-half of the principal amount of the note. If such payments were not made within 4 years following the execution of the note, however, the seller acquired exclusive rights to distribute video cassettes and video discs of the production. Thereafter, the liability of the limited partners would terminate if 4 million (5 million in the case of MBL) video disc and video cassette players had been sold in the United States, and $100,000 of gross distribution revenues were received after the end of the fourth year but before the maturity date of the note.

The principal amount of the note was determined by using the following method: (1) The approximate cash cost of the production was determined; (2) the amount to be deferred was calculated by subtracting the amount of the cash down payment from the estimated cash cost of the production; (3) the amount to be deferred was "capitalized" at an annual interest rate of 20 percent over the term of the note;[3] and (4) this "capitalized" amount was increased by approximately 25 percent, so as to provide the seller with a profit. The note's 9-percent stated interest accrued on the principal amount of the note calculated by this method. For each of the productions here under consideration, petitioner believed that the cash cost of production would be approximately $725,000.

Offering Memoranda

The offering memorandum for each of the partnerships contained a section entitled "Suitability Standards for Investors," which required a potential investor to represent that he had a net worth of at least $150,000 (excluding home, home furnishings, and automobiles) or that he expected to have income during the year of investment and the succeeding year, which is taxable in a Federal tax bracket in excess of 50 percent, or if a corporate investor, taxable at the maximum regular corporate rate. The reasons given for this requirement were that the partnership interests were relatively illiquid and "that the relative financial benefit of an investment in the Partnership will generally depend substantially on the tax bracket of the investor."

The cost of a limited partnership unit, the number of units offered, the minimum number of units which could be purchased, and the total anticipated capitalization for each of the partnerships, as set out in the offering memoranda, were as follows:

	CFL	*GMS*	*MWL*	*MBL*
Cost of one unit	$1,000	$1,600	$1,150	$1,200
Total number of units offered	350	250	350	350
Minimum units per investor	10	10	10	10
Total anticipated capitalization	350,000	400,000	402,500	420,000

The estimated use of these proceeds was shown to be as follows:

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[3] Under the plan used by petitioner, this "capitalization" was done by determining the future value in 7 years of the amount to be deferred using a 20-percent annually compounded interest rate. This is done by multiplying the deferred amount by 1.20 or approximately 3.58. See Compound Interest and Annuity Tables, p. 1840 (C. Gushee 6th ed. 1980).

	CFL	*GMS*	*MWL*	*MBL*
Cash downpayment for production	$230,000	$230,000	$250,000	$270,000
First year interest payment[1]	30,000	30,000	30,000	40,000
General partner's fee[2]	32,000	30,000	26,275	40,000
Legal and accounting costs[3]	21,000	25,000	35,000	30,000
Partnership working capital	- - -	- - -	- - -	15,000
Reserve[4]	37,000	25,000	25,000	25,000
Sales commissions	- - -	30,000	36,225	- - -
Total	350,000	370,000	402,500	420,000
Proceeds unaccounted for	- - -	30,000	- - -	- - -

[1] This was variously designated as "interest prepayment," "interest prepayment and reduction of principal" or "interest payment on the purchase price note."

[2] This was designated as either "general partner's initial management fee" or "general partner's fee for services in organizing the partnership."

[3] The MWL offering memorandum listed this as "legal and accounting costs incurred in connection with the offering and organization of the partnership."

[4] The reserve was designated as either "reserve for operations, extraordinary expenses and annual interest requirement," "reserve for accounting and legal fees in the event of an audit by the Internal Revenue Service," "reserve for operations, extraordinary expenses, annual interest requirement, working capital and other liabilities of the partnership" or "Internal Revenue Service reserve."

The memoranda also informed the potential investor that a limited partner could be subject to an annual assessment if necessary to allow the partnership to meet its annual minimum interest payments.

The per-unit cost of a partnership interest was not identified as including any portion of the liabilities to be assumed by the limited partners. The requirement that the limited partners execute the assumption agreements was explained in a section of the offering memoranda entitled " 'At Risk' Provisions." This section explained that, due to the Tax Reform Act of 1976 and the Revenue Act of 1978, the investors would be limited in recognizing losses from the partnership to the extent their investment was "at risk." A partner's amount "at risk" was defined as "the amount of his actual net cash investment in the Partnership, plus the portion of any Partnership liabilities for which such limited partner is personally liable." Immediately following this explanation, it was stated that each investor would be required to accept personal liability for a pro rata portion of the principal amount of the purchase price note. This section also explained that the requirement of personal liability materially increased the risks to investors and that no party involved with the investment or production guaranteed that sufficient revenues would be generated to cause the purchase price note to become nonrecourse.

The offering memoranda stated the purchase price which would be paid by each of the partnerships and that each of these purchase prices was based on "a represented projected production cost."[4] The purchase prices and the represented projected production costs for each of the productions to be acquired were shown to be as follows:

Partnership	*Purchase price*	*Production cost*
CFL	$2,300,000	$1,650,000
GMS	2,300,000	1,800,000
MWL	2,320,000	1,624,000
MBL	2,300,000	1,700,000

In none of the memoranda was it represented that the purchase price was the fair market value of the production or that the represented projected production cost was a reasonable production cost.

The section of the operating memoranda entitled "Anticipated Results of Operations," stated that while the ultimate goal of the partnership was to profit from the exploitation of the production, it was anticipated that during at least the first 2 years of operation, losses would be incurred by the partnership. Schedules contained in the CFL and GMS offering memoranda showed anticipated expenses for the two partnerships during the years in issue, their first 3 years of operation, to be as follows:[5]

	CFL			*GMS*		
	1979	1980	1981	1979	1980	1981
Depreciation	$214,285	$582,994	$420,506	$80,357	$620,409	$447,231
Legal and accounting	10,000	1,500	1,500	15,000	1,500	1,500
Organizational fees	1,300	2,600	2,600	1,000	8,000	8,000
G/P management fee	32,000	1,200	1,200	---	3,000	3,000

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[4] From the context in which it is used, this appears to mean represented by either the executive producer or producer.

[5] These schedules also showed anticipated investment tax credits of $153,000 in 1979 for each of the partnerships.

	CFL			*GMS*		
	1979	1980	1981	1979	1980	1981
Interest expense[1]	$62,100	$174,842/ 186,300	$129,546/ 186,300	$29,510	$208,102/ 211,243	$164,907/ 187,294
Total expenses	319,685	763,136/ 644,594	555,352/ 612,106	125,867	841,011/ 844,152	624,638 647,025

[1] The variation in interest expenses for the years 1980 and 1981 is a product of hypothetical assumptions about the amount of principal paid down in those years. The offering memoranda did not give these figures as projections of the amounts of principal which would be paid down in the years in issue.

No such breakdown of anticipated expenses was given in the MWL or MBL offering memorandum. None of the memoranda made projections of, or representations concerning, the income stream that could be expected from the exploitation of the productions.

Petitioner was the sole general partner of CFL and MBL, but was a co-general partner with Henry L. Chiesa in GMS and MWL. The offering memoranda identified petitioner as a certified financial planner, who acts as an insurance broker and general agent. Chiesa was identified as the president, chief executive officer, and principal stockholder of Managed Investments, Inc., a broker/dealer.

The risk factors listed in the memoranda included the lack of experience of the general partner(s) in acting as a general partner of a limited partnership and lack of experience in the production, distribution, and exploitation of the type of productions involved. The memoranda also stated that the general partner(s) would rely substantially on the efforts of the sellers, executive producers, producers, and distributors, and that while the general partner(s) would have sole control of the management of the partnership, he (they) would not be required to devote full-time efforts to the affairs of the partnership. The CFL and GMS memoranda also noted that the producer of the series had been in business for only a short time (1½ to 2 years), that the distributor was a newly formed subsidiary of the producer, and that neither the producer nor the distributor had previous experience distributing television series. The MBL and MWL memoranda stated that the producer had no other experience in producing videotapes of Shakespeare's plays and that there was insufficient prior experience concerning the distribution of theatrical videotapes for reliable estimates to be made of likely distribution revenues.

The general partner(s) received a 1-percent share of the profits, losses, and distributable cash-flow of the partnership in exchange for a cash investment of $1,000. As compensation for acting as general partner(s), the offering memoranda stated that petitioner (and Chiesa in GMS and MWL[6]) would receive: (1) An initial fee, from the proceeds of the offering, for services rendered in organizing and managing the partnership; (2) an annual management fee commencing in the second year of partnership operations, which would be paid from net cash-flow of the partnership after the minimum interest payments had been made in each year; and, (3) if the limited partners received cash distributions equal to 125 percent (100 percent in the case of CFL) of their cash investment and were no longer personally liable on the purchase price note, an increased percentage of distributable cash-flow. The amounts of the initial fees, annual fees, and increased percentage of distributable cash flow were as follows:

	CFL	*GMS*	*MWL*	*MBL*
Initial fee	$32,000	$30,000	$26,275	$40,000
Annual fee	1,200	3,000	3,000	3,000
Increased percentage	11%	34%	34%	34%

The CFL and GMS offering memoranda stated that of the amounts paid to the seller of the production to reduce the purchase price note, 20 percent would be paid to Century as compensation for its services as executive producer, 75 percent would be paid to Solaris, and 5 percent would be retained by the seller. The MWL memorandum stated that of the amounts paid to the seller, 70 percent would be paid to the producer. The executive producer was to receive no compensation for acting as executive producer of Merry Wives, other than the indirect benefit of the amounts retained by the seller, its wholly owned subsidiary. The MBL offering memorandum did not designate the portions of the amounts paid to the seller which were to be passed on to the producer and executive producer.

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[6] The offering memoranda for GMS and MWL did not state the amounts of fees due the general partners separately, but only gave aggregate amounts.

Productions

In 1979, CFL and GMS financed the production of two 13-episode children's series entitled "Memoirs of a Fairy Godmother" (Memoirs) and "Geppetto's Music Shop" (Geppetto's), respectively. CFL acquired all rights to Memoirs from Justin-Pacific Corp. V (JPV), a wholly owned subsidiary of Century. GMS acquired all rights to Geppetto's from Justin-Pacific Corp. II (JPII), another wholly owned subsidiary of Century. Century was the executive producer for each of these productions and created the Justin-Pacific subsidiaries for the sole purpose of financing their respective productions. Both Memoirs and Geppetto's were produced by Solaris.

In 1980, MWL purchased all rights to a master videotape of Shakespeare's play "The Merry Wives of Windsor" (Merry Wives) from Bard I, Inc. (Bard I), a wholly owned subsidiary of Bard Productions, Ltd. (Bard). Bard was the executive producer of Merry Wives and was formed by Scheer and Francoeur to produce Shakespeare's canon of plays on videotape. Merry Wives was produced by and taped at the facilities of the Shakespeare Society of America (SSA). SSA was a nonprofit corporation which produced live Shakespearean plays, but which had no prior experience in the production of videotaped plays.

Merry Wives was originally planned for production in 1979, with funding to come from Windsor Partners, a partnership in which petitioner would have again been the general partner. The videotaping of Merry Wives was completed in 1979, but the partnership was not fully subscribed by the end of that year. As a result, Windsor Partners was abandoned in December 1979, and the investors who had subscribed to interests in Windsor Partners had their contributions transferred to, and became limited partners in, GMS. MWL was then formed in 1980 to acquire Merry Wives from Bard I.

In 1981, MBL financed the production of a videotaped version of Shakespeare's play "Macbeth." MBL acquired all rights to the production from Bard II, Inc. (Bard II),[7] a wholly owned subsidiary of Bard. Bard was the executive producer of Macbeth and the Shakespeare Video Society (SVS), a nonprofit corporation, was the producer.[8] SVS was formed to produce Shakespearean plays for Bard because of severe production problems encountered in SSA's production of Merry Wives.[9] The principals of SVS, however, were independent of Bard.

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[7] JPII, JPV, Bard I, and Bard II each had an initial capitalization of $1,000 and no additional capital was ever added.

The parties involved with the productions, the amounts paid by the partnerships to purchase their respective productions, and the terms of the notes executed by the partnerships were as follows:

	CFL	*GMS*	*MWL*	*MBL*
Seller	JPV	JPII	Bard I	Bard II
Executive producer	Century	Century	Bard	Bard
Producer	Solaris	Solaris	SSA	SVS
Execution date of acquisition agreement	10/4/79	10/4/79	12/31/80	10/21/81
Total purchase price	$2,300,000	$2,300,000	$2,320,000	$2,300,000
Cash down	$230,000	$230,000	$250,000	$270,000
Principal amount of note	$2,070,000	$2,070,000	$2,070,000	$2,030,000
Execution date of note	10/4/79	11/18/79	12/31/80	10/21/81
Maturity date of note	2/01/87	2/01/87	2/01/88	2/01/89
Payments required to trigger conversion in first 4 years	$1,035,000	$1,035,000	$1,035,000	$1,015,000

By 1978, Glenn Taylor had established an ongoing business relationship with Scheer and Century. In 1979, Solaris was Century's only producer, and Scheer neither negotiated with other producers nor cost-shopped with respect to the productions. At the time discussions began between Scheer and Solaris with respect to the production of Memoirs and Geppetto's, Solaris had produced more than 100 children's shows for Century.

At the time petitioner became a general partner in each of the four partnerships, Scheer had already set the terms upon which the videotapes would be produced. As a result, there were no negotiations between petitioner and Scheer with respect to the prices to be paid by the partnerships for the videotapes. Petitioner did not request that Scheer obtain other bids for the production of Memoirs or Geppetto's. Nor did petitioner inquire into the actual costs of Solaris in producing Memoirs and Geppetto's.

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[8] The MBL offering memorandum states that SSA was to be the producer of Macbeth, but SVS was substituted for SSA.

[9] The production problems encountered with Merry Wives appear to have resulted from the fact that SSA's theater was not adequately designed for the videotaping of a play.

In 1979, both Century and Solaris made estimates of the production costs of Memoirs and Geppetto's. These estimates were based on the concept of executing notes with principal amounts in excess of the cash costs for certain of the expenses. John Filatreau, Solaris' accountant, developed the Solaris estimates by taking the production order subcontract price and backing out allocations by use of "accountant's license." No amount was allocated to Solaris' profit margin. Following the production of Memoirs and Geppetto's, Filatreau prepared a schedule of Solaris' production costs and profit markup by allocating expenses from the company financial records. The partnership returns for CFL and GMS also list costs for the productions, but the costs are not broken down and they include Century's profit margins (which were not included in any of the other cost statements). These cost statements are summarized as follows:

For Memoirs—

	Solaris estimate	*Century estimate*[1]	*Solaris cost schedule*	*Partnership return*
Story	$263,300	$232,700	$403,750	---
Supervisors	277,700	101,400	170,000	---
Cast	200,000	131,300	77,625	---
Direction	100,000	104,000	170,000	---
Total above-the-line cost	841,000	569,400	[2]821,375	---
Total below-the-line cost	861,500	730,600	289,685	---
Total cost of shows	1,702,500	1,300,000	1,111,060	2,050,000
Record albums, cassettes, and storybooks	---	650,000	---	150,000
Ancillary rights	---	---	---	100,000
Markup	---	---	591,440	---
Dated	10/30/79	1/07/79	---	3/18/81

[1] The Century estimates were actually prepared on a per-episode basis. Scheer testified that the proper estimates for the cost of each series could be obtained by multiplying the figures by 13, the number of episodes in each series. For comparison purposes, we have done so.

[2] For both Memoirs and Geppetto's, Solaris' post-production cost schedules designate the above the line costs as deferred costs.

For Geppetto's—

	Solaris estimate	*Century estimate*	*Solaris cost schedule*	*Partnership return*
Story	$263,300	$299,000	$403,750	. . .
Supervisors	277,700	104,000	170,000	. . .
Cast	200,000	187,200	77,625	. . .
Direction	100,000	104,000	170,000	. . .
Total above-the-line cost	841,000	694,200	821,375	. . .
Total below-the-line cost	861,500	930,800	289,685	. . .
Total cost of shows	1,702,500	1,625,000	1,111,060	$2,300,000
Record albums and cassettes	. . .	260,000	. . .	. . .
Storybooks	. . .	65,000	. . .	. . .
Markup	. . .	. . .	591,440	. . .
Dated	12/21/79	11/01/79	. . .	3/13/80

The Century cost estimates were purportedly provided to petitioner prior to his entering into the acquisition agreements. As to Geppetto's, however, the acquisition agreement was executed prior to the date shown on the Century cost estimate. The dates shown on the Century cost estimates for each of the productions and the execution dates for each of the acquisition agreements also precede the dates shown on the Solaris cost estimates.

The amounts designated as the costs of the "story" in each of the cost breakdowns were amounts to be paid by Solaris to Syntar, Glenn Taylor's wholly owned company, pursuant to licensing agreements. These agreements gave Solaris the right to use the story lines as developed by Syntar in exchange for $425,000 per production. For each of the productions, $21,250 was to be paid upon execution of the contract, and the balance of $403,750 was to be paid out of 30 percent of all moneys received by Solaris after Solaris had received $300,000. As to both productions, the licensing agreements were dated earlier than the Solaris cost estimates, but the Solaris cost estimates do not accurately reflect the agreed costs of the story lines. The amounts reflected on the Solaris cost schedules reflect the deferred portions of the agreed costs.

Solaris also executed administrative consulting contracts with Syntar for Memoirs and Geppetto's. Each of the contracts required Solaris to pay to Syntar, in exchange for

Syntar's consulting services, 14 percent of all moneys received by Solaris from the production after Solaris had received $486,500. It is unclear whether any of the cost estimates for Memoirs or Geppetto's reflect amounts to be paid by Solaris pursuant to these contracts, but if Solaris were paid the full $1,702,500 due it, the payments required to be made to Syntar pursuant to the consulting contracts would be approximately $170,000, the amount shown in the Solaris cost schedule for "Supervisors."[10]

While the Century cost estimate for Memoirs shows a total estimated cost for record albums, cassettes, and storybooks of $650,000, the CFL partnership return shows a cost basis in those items totalling only $150,000. The Century cost estimate for Geppetto's shows a total estimated cost for these items of $325,000, but the GMS partnership return does not claim any cost basis in such items.

Century also made estimates of the production costs of Merry Wives and Macbeth based on the concept of executing notes with principal amounts in excess of the cash costs for certain of the expenses. These cost estimates are summarized as follows:

	Merry Wives	*Macbeth*[1]
Story	$500	$500
Supervisors	406,350	436,350
Cast	420,350	420,350
Direction	130,900	150,900
Total above-the-line cost	958,100	1,008,100
Total below-the-line cost	482,850	522,850
Total direct cost	1,440,950	1,530,950
Contingency	57,750	57,750
General studio overhead	111,300	111,300
Total cost	1,610,000	1,700,000

[1] The cost estimate for Macbeth is dated July 1980. This is prior to the formation of SVS, the producer of Macbeth.

The production order subcontract executed between Bard I and SSA obligated Bard I to pay $1,624,000 to SSA in consideration for the production. Of this amount, $175,000 was to be paid upon execution of the contract, and the balance, together with interest at the rate of 9 percent per annum, was due on or before February 1, 1988. The contract also required Bard I to make interest and principal payments from 70 percent of any payments received from MWL.

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[10] This is calculated as follows: ($1,702,500 − $486,500) × $0.14 = $170,240

While a production order subcontract was the focus of negotiations between Bard II and SVS, such a contract was not, in fact, ever executed. The understanding developed between Bard II and SVS was that Bard II would provide a certain amount of cash for the production of the play and that 70 percent of the amount received by Bard II from MBL would be paid to SVS. SVS was not involved in setting the $2.3 million price which was to be paid by MBL, nor did SVS attempt to bargain for an interest in MBL's note in excess of the 70 percent it was offered by Bard II. The original cash budget agreed to was $225,000, but this was later increased to $245,000.

The 70-percent interest of SVS in MBL's obligation to Bard II was actually obligated to members of the production staff, cast, and crew of Macbeth as compensation for their services. This was done by the manager of SVS, Susan Marrone, negotiating percentage interests with these individuals, and Bard II (not SVS) executing 7-year notes for the negotiated percentages. These notes bore interest at 9 percent and were to be paid out of their stated percentages of amounts received by Bard II from SVS.[11] Two sets of notes, however, were actually executed by Bard II for this purpose. The original set of notes provided that if the principal had not been paid in full as of the maturity date, no further payments of principal or interest were to be made unless Bard II regained possession of the videotape and thereafter commercially exploited the videotape. The second set of notes, which replaced the original set, provided that if the principal and interest had not been paid in full as of the maturity date, all such amounts were then payable in full from Bard II.

Independent of the production order subcontract which had been executed by Bard II and SSA, the actual production arrangements for Merry Wives were similar to those for Macbeth. Bard I executed notes in favor of members of the production staff, cast, and crew representing 70 percent of MWL's obligation to Bard I. This left Bard I obligated to SSA for only the cash amount agreed to in the production order subcontract. The notes executed by Bard I were similar to the second set of notes executed by Bard II for Macbeth and were not executed until early 1982. This was after the second set of notes was executed by Bard II and more than 2 years after the videotaping of Merry Wives.

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[11] This scheme guaranteed that those holding the notes would at least receive a percentage of the minimum interest paid by the partnership.

Both SSA and SVS were required to enter into agreements with the American Federation of Television and Radio Artists (AFTRA) prior to the production of Merry Wives and Macbeth. Both of these agreements were nonbroadcast production agreements. The agreement entered into by SSA allowed for broadcast uses of the production (i.e., use by network television, syndicated television, public television, and pay television) only if SSA paid to the AFTRA members additional compensation as set forth in the AFTRA code. The agreement entered into by SVS, however, provided that SVS was required to notify AFTRA at least 60 days prior to the date of any broadcast use of the production and that SVS would then be required to bargain with AFTRA for the amount and terms of additional compensation to be paid the AFTRA members. The agreement also provided that the production was not to be released for broadcast use pending an agreement between SVS and AFTRA as to such additional compensation.

In 1980, CFL made loans to Century in at least the amount of $28,400. The loans were payable on demand and earned interest "at the prevailing rate of 'Fidelity cash reserve money market fund.' " By the beginning of 1983, the total loan balance owed CFL by Century was $40,588.32. This amount was used as an offset in 1983 to unpaid 1982 minimum interest and 1983 minimum interest owed JPV by CFL.

In 1981, a receivable was created in favor of GMS in the amount of $24,912 with the same interest provisions as those applying to the loans from CFL to Century. This receivable resulted from overpayments to JPII and Century by GMS and Windsor Partners. As of the end of 1982, the balance owing on the receivable was $32,634.58. This amount was then used as an offset to the 1982 minimum interest owed JPII by GMS.

In 1981, a receivable was created in favor of MWL by Bard I in the amount of $12,000 with the same interest provisions as above. This receivable resulted from overpayments by MWL to Bard I. At the end of 1983, the balance owing on the receivable was $17,048.26. This amount was then used as an offset to the 1983 minimum interest owed Bard I by MWL.

In 1981, MBL loaned Century $25,000 for which Francoeur, as president of Century, executed a demand note in favor of Managed Investments, Inc., Chiesa's company. The note provided that in the event that the balance due was not paid on demand, interest would be added at a rate of 15 percent per annum. The note did not provide for the payment of any other amounts as interest.

Distribution Efforts

Because of his lack of experience in the area, petitioner relied on the advice of others, primarily Scheer, with respect to distribution strategy and the choice of distributors. Petitioner had a clear understanding prior to the startup of the partnerships that Scheer and Century would take the responsibility for placing the shows in distribution. In fact, each of the distribution contracts executed by the partnerships was negotiated by Scheer or another agent of Century.

Initially, the distribution contracts entered into by the partnerships were nonexclusive arrangements. Scheer negotiated nonexclusive contracts for two reasons: (1) He had been advised that if an exclusive distribution contract were executed and the distributor failed to make money, the partnership involved could lose its investment tax credit; and (2) Scheer considered himself to be an amateur in the distribution business and therefore wished to have flexibility with respect to the distribution contracts he negotiated for the partnerships.

Memoirs and Geppetto's were initially to be distributed by Solaris International Distributors, Inc. (SID), a wholly owned subsidiary of Solaris, pursuant to a nonexclusive distribution contract. Neither SID nor Solaris, however, had any previous experience distributing television series. SID attempted to find responsible syndicators to aid it in distributing the series, but the decision was eventually made by Solaris personnel that SID was not reasonably equipped to accomplish television distribution. No actual marketing of Memoirs or Geppetto's was ever accomplished by SID.

Prior to 1982, the partnerships entered into distribution contracts with the following distributors:

Date	Partnership	*Distributor*
2/19/80	CFL	Videotheque Entertainment Corp.
11/01/80	CFL	Joseph Green Pictures
4/81	CFL	Telepictures Corp.
11/02/81	CFL	Cinaco Television Co.
2/19/80	GMS	Videotheque Entertainment Corp.
11/01/80	GMS	Joseph Green Pictures
4/81	GMS	Telepictures Corp.
11/02/81	GMS	Cinaco Television Co.
3/09/81	MWL	Videotheque Entertainment Corp.
10/21/81	MBL	Videotheque Entertainment Corp.

Each of the above contracts granted certain distribution rights to the distributor in exchange for the distributor's agreement to pay over to the partnership a specified percent of the distributor's gross receipts or gross income from distribution of the production.[12] The contracts required nothing more of the distributors than that they act in good faith or with best efforts in pursuing the distribution of the products.

In 1982, distribution contracts were entered between CFL and Century Home Video (CHV) and between GMS and CHV with respect to the distribution of Memoirs and Geppetto's in the home video market. CHV was a new distribution company incorporated by the principals of Century and 50 percent owned by Scheer. These contracts gave CHV exclusive worldwide rights to the distribution of Memoirs and Geppetto's in the home video market for a period of 20 years. As executed by petitioner, however, these contracts purported to forbid CFL or GMS from bringing any action or proceeding against CHV based on a claim that CHV had not properly distributed the productions. The contracts also gave CHV the right to execute further distribution contracts without the approval of petitioner.

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[12] This scheme guaranteed that those holding the notes would at least receive a percentage of the minimum interest paid by the partnership.

Contracts identical to the CHV contracts were also executed in 1982, between MWL and Bard Home Video (BHV) and between MBL and BHV. BHV was another distribution company incorporated by the principals of Century.

Income Projections

Merry Wives was the only production which petitioner had reviewed by an appraiser prior to entering into the acquisition agreement for the production. Merry Wives was also the only production which was in its finished form and which petitioner viewed prior to its acquisition. The appraisal report was done by Toluca Productions and signed by Bill Eliscu. It was dated May 30, 1980. The report predicted that in the following 5-year period, Merry Wives would generate $5.1 million in gross receipts, broken down as follows:

Commercial U.S. Television	
First runs	$600,000
Reruns	700,000
Foreign television	650,000
Cable television	1,000,000
Closed circuit television	250,000
Educational market	400,000
Prerecorded videotapes and discs	1,700,000
Total	[1]5,100,000

[1] The report showed the sum of these numbers to be $5.1 million, while the actual sum is $5,300,000.

Eliscu based his estimate of U.S. commercial television receipts on an assumption that 6 percent of the U.S. commercial television stations would air the play, paying an average of $10,000 for a first run and airing it again once every 2 years at a lesser rental. The basis for assuming a 6-percent market penetration and a $10,000 average first run rental fee was not explained. The foreign television revenues were assumed to be 50 percent of the total U.S. commercial television revenues. Similarly, the only bases stated for the estimate of cable television revenues were that this medium was the fastest growing of any and that the revenues it would produce should almost equal revenues from commercial television. The basis for the estimate of closed circuit television revenues was also stated to be the rate of growth of the medium.

The estimated revenues from the educational market were stated to result from the fact that Shakespeare's plays were well suited to the market and that there were more than 100,000 libraries, high schools, and junior and senior colleges to which videotapes, videodiscs, and motion picture films could be sold. The estimate of revenues from the sale of videotapes and videodiscs stated that this market should be sufficiently developed by late 1982 for Merry Wives to begin selling, and that by the end of 1985, revenues should equal $1.7 million. This estimate was based on 1 million videotapes and videodiscs being sold for a retail price of $15 to $20 each, and a royalty to the owner of 10 percent of the retail price.

The report consisted of two typed pages and did not estimate the fair market value of Merry Wives.

Operating Results

During the years in issue, the partnerships reported the following losses on their partnership tax returns:

	1979	*1980*	*1981*
CFL	$241,020	$791,551	$617,685
GMS	120,677	881,243	468,981
MWL	---	479,978	583,125
MBL	---	---	400,806

Distribution of Memoirs and Geppetto's returned income to their respective partnerships during the period 1979 through 1984 totaling $5,000 to $10,000. Distribution of Macbeth during the period 1981 through 1984 returned income to MBL totaling $3,000 to $4,000. Through 1984, MWL had not received any income from the distribution of Merry Wives.

During 1983 or 1984, each of the partnerships had fallen in arrears on minimum interest payments. While the notes provided that a default on minimum interest payments allowed the holder of the note to accelerate the partnerships' liability for the unpaid principal, such action had not been taken against any of the partnerships and Scheer did not intend to take such actions against the partnerships.

OPINION

A. Economic Substance

The first issue for our consideration is whether the transactions between the partnerships, executive producers, and producers were tax shams lacking economic substance.

Transactions which are entered solely for the purpose of obtaining tax benefits and which are without economic substance are considered shams for Federal income tax purposes and will not be given effect. *Knetsch v. United States*, 364 U.S. 361 (1960); *Falsetti v. Commissioner*, 85 T.C. 332 (1985). The economic substance of a transaction, not its form, is controlling. *Gregory v. Helvering*, 293 U.S. 465 (1935). We have defined " 'sham in substance' as the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Falsetti v. Commissioner*, *supra* at 347. In *Falsetti*, we viewed the totality of facts and circumstances as establishing that a purported purchase of real property was in substance a sham. In determining that the purchase lacked the requisite economic substance, we took into consideration the absence of indicia of arm's-length dealing, drastically inflated sales prices, and a complete disregard of contractual terms.

Respondent contends that there was no justification for the partnerships' acquisitions of the videotapes other than expected tax benefits. Respondent alleges that prior to the transactions, petitioner failed to take the steps a prudent businessman would take prior to making a purchase for more than $2 million, and that his actions were those of a tax shelter promoter trying to document and substantiate transactions in the event of an Internal Revenue Service examination. Respondent further alleges that the purchase price was inflated and was the result of a lack of arm's-length negotiations, and that, if the notes failed to convert to nonrecourse by their maturity dates, the parties did not intend to enforce them.

Conversely, petitioner asserts that the structure of the purchases by the partnerships has economic substance in that the purchases were not motivated solely by tax-avoidance purposes. The burden is upon petitioner to prove this assertion. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Petitioner must demonstrate that the purchases here in issue were in fact made with the intent of acquiring a profit-generating property for which notes would be executed and enforced in accordance with their terms. Absent such a showing, these transactions can be viewed as merely an attempt by the partnerships to obtain a $2.3 million depreciable tax basis ($2,320,000 in the case of MWL), yearly interest deductions for 7 years, and investment tax credits in exchange for the payment of $230,000 in year 1 ($250,000 for MWL and $270,000 for MBL) and a payment of $52,000 in each of the following 7 years.

We find that the purchases of the videotapes in this case were completely lacking in economic substance and cannot be recognized for Federal tax purposes. While our conclusion that these transactions were in substance shams is based on a careful review of the entire record, we find the following factors, taken together, to be particularly determinative in reaching this conclusion:

1. *Arm's-Length Dealings*

From the record, it is indisputable that the partnerships here involved did not attempt to negotiate for a purchase price which was less than the $2.3 million price ($2,320,000 in the case of MWL) set by Scheer. Petitioner has not argued to the contrary. Rather, petitioner argues that the purchase price for each of the videotapes was reasonably based on the costs of production as negotiated by Scheer.

We do not believe that petitioner attempted to determine, nor that he was capable of determining, whether the purchase prices were reasonable. Prior to becoming a general partner in the partnerships here involved, petitioner had no experience in the managing of a limited partnership, the production of videotapes, or the distribution of videotapes. The creation of tax-oriented investments for the financing of videotaped productions was an ongoing activity of Century and Solaris. Petitioner was brought into this activity solely because of his ability to obtain investors. Scheer controlled the structuring of the transactions, the choice of production arrangements, and the distribution of the productions, while petitioner's involvement, other than obtaining investors in exchange for general partner's fees and sales commissions, was token.

Further, while petitioner claims that the purchase prices for the videotapes were based on "capitalizing" the estimated cash costs of production, the only preproduction cost estimates which have been offered as evidence were based on the use of deferred obligations to cover a large portion of the production costs. The Solaris cost estimates were prepared by taking the production order subcontract price and allocating it to the various cost categories by the use of "accountant's license." The cost estimates did not allocate any amount to Solaris' profit margin, even though the cost schedules prepared by Solaris after the productions were completed show that its profit margin was nearly $600,000 per production. The Solaris cost estimate for Memoirs and the Solaris and Century cost estimates for Geppetto's were each dated later than the dates upon which petitioner signed the acquisition agreements on behalf of the partnerships. In addition, even if petitioner had received estimates of the cash costs of the productions prior to executing the acquisition agreements, he could not have determined whether the estimates were reasonable without the aid of someone more experienced in the industry.

Even though he argues that such costs were the basis for each of the partnerships' $2.3 million purchases, there is no credible evidence in the record that petitioner attempted to independently determine what reasonable production costs for the videotapes would have been if based on the use of cash only. Further, petitioner's claim that $725,000 was a reasonable estimate of the cash cost of producing each of the videotapes is contradicted by respondent's expert on the production of videotapes, Adrian H. Joseph.[13] Joseph was president of Ultimate Video, Inc., a full service teleproduction company, and previously had 13 years of experience as a producer and associate producer of programming while employed by network-owned television stations. Joseph has also acted as a freelance producer and writer of television programs and video products. In his expert witness report, Joseph estimated reasonable budgets for the production of the videotapes here in issue at the times they were produced, including in each case a 15-percent contingency amount, to be as follows:

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[13] Petitioner introduced the testimony of an expert witness, Warren Baker, on the subject of all cash production costs, but did not introduce an expert's report. Baker's testimony as to the all cash production costs was based on his view of what the production arrangements actually were as established by the evidence received at trial up to the time of his testimony. We find this testimony to be extremely speculative in nature and of little value.

Production	*Budget*
Memoirs	$222,846
Geppetto's	225,628
Merry Wives	17,877
Macbeth	371,605

In conjunction with this, we note that although two of the productions were 13-episode children's series and two were Shakespearean plays, and the record shows that their production arrangements differed substantially, the purchase price for each was virtually identical. This is clearly indicative of transactions that have been contorted to fit into a standardized tax model, rather than being structured to fit economic realities, and which are the result of a single individual's controlling both sides of the transactions.[14]

In sum, a close examination of the record reveals a complete lack of arm's-length dealing with respect to the contracts entered into by the partnerships, and we therefore do not believe that from an economic standpoint they can be relied on to accurately characterize the nature of the transactions here under consideration. See *Karme v. Commissioner*, 73 T.C. 1163, 1186 (1980), affd. 673 F.2d 1062 (9th Cir. 1982).

2. *The Partnership Notes*

a. *Terms of the Notes*

Petitioner argues that the purchase price of each of the productions was predicated upon an estimated cash cost of $725,000 per production. Petitioner alleges that this was a reasonable estimate of the cash payment that would have been required to produce each of the productions without the use of deferred obligations.[15] Petitioner further alleges that the face amount of each of the notes executed by the partnerships was determined by (1) subtracting the downpayment from $725,000 to determine the amount to be deferred, (2) calculating the future value of this deferred amount in 7 years using a 20-percent annual interest rate, and (3) increasing this future value by approximately 25 percent, as the executive producer's profit margin. For Memoirs, this calculation can be illustrated as follows:

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[14] See *Pittler v. Commissioner*, T.C. Memo. 1986-320.

[15] As we stated above, the record does not indicate that petitioner attempted to determine the reasonable costs of production prior to executing the acquisition agreements.

Cash cost	$725,000
Amount deferred	$725,000 − $230,000 = $495,000
Future value of amount deferred	$1.20^7 \times \$495{,}000 = \$1{,}773{,}585$
Increased by 25 percent	1.25 × $1,773,585 = $2,216,981
Actual face amount of note	$2,070,000

Petitioner also alleges that at the time each of the partnerships entered into its acquisition agreement, an annual interest rate of 20 percent was reasonable.

Accepting, arguendo, petitioner's assertions that $725,000 was a reasonable estimate of the cash cost of each of the productions and that 20 percent was a reasonable interest rate, petitioner has completely ignored the effect of the 9 percent interest which was applied to the face amount of the notes. The result of applying a 9 percent interest rate to a principal amount determined by petitioner's method is the equivalent of paying an effective minimum annual interest rate of approximately 52 percent on the deferred portion of the cost of the production. Assuming an amount to be deferred of $1 and that the principal amount of the note remains unpaid until the end of the note's term, this can be illustrated as follows:

Amount deferred	$1
Future value of amount deferred	$1.20^7 \times \$1 = \$3.58$
Effective annual interest	(0.09 × $3.58) + $0.20 = $0.52
Effective annual interest rate	52%

If principal is paid before the end of the note's term, the effective interest rate paid on the deferred portion of the production costs increases. In the extreme case, where the entire principal is paid in a lump sum at the end of the first year, the effective interest rate paid on the deferred portion of the production costs would be approximately 290 percent.

Using the same figures as above, this can be illustrated as follows:

Amount deferred	$1
Face amount of note	$3.58
Payments made at end of year	(0.09 × $3.58) + $3.58 = $3.90
Payments made in excess of amount deferred	$3.90 − $1 = $2.90
Effective interest rate	290%

In choosing the form of the notes that the partnerships would execute, Scheer set the principal amounts of the notes so as to create a 20-percent annual rate of return over 7 years absent any interest accruing on the principal. Scheer then, however, applied a 9-percent interest rate to the principal of the notes, resulting in the partnerships' being obligated to pay the equivalent of at least a 52-percent interest rate. We find it extremely difficult to believe that any investor would be willing to pay the equivalent of a 52-percent interest rate on an investment entered into for economic reasons. Petitioner has not, however, disputed any of the facts that would lead to the conclusion that if the nature of the transactions here involved are accurately characterized by the documents which have been drafted to substantiate them, petitioner and the other investors would be paying the equivalent of a minimum 52-percent interest on what they claim to be the deferred portion of the production costs. We find this, in conjunction with other indicia of mischaracterization, to suggest that the substance of the transactions here under consideration is neither accurately characterized by the documentation nor a product of economic considerations.

b. *Enforcement of the Notes*

While the notes executed by the partnerships had apparently not converted to nonrecourse as of the time of trial, the record in this case casts doubt on whether the parties intended to enforce the notes upon maturity. Because of the ongoing relationship of those within Century, Solaris, and Syntar, and their almost complete control of the form of the transactions here involved, evidence of the ability of someone not closely involved with Century, Solaris, or Syntar to enforce the partnership notes, either directly or indirectly, would constitute strong evidence of the parties' intent to have the notes enforced.

As to Memoirs and Geppetto's, the cost schedule prepared by Solaris is very informative with respect to determining the parties who held the ultimate interests in the $2,070,000 partnership obligations. Syntar had a total deferred interest in each of the productions pursuant to its consulting and licensing agreements of $573,750. Solaris' profit margin for each production, which based on the evidence must have been a deferred interest, was $591,440. The deferred portion of Century's markup on the production order subcontract prices was approximately $570,000 for each of the productions. Therefore, more than $1.7 million (or more than 80 percent) of each of the CFL and GMS notes was ultimately obligated to either Century (or one of its wholly owned subsidiaries), Solaris or Syntar, and would not be enforced unless they chose to take action against the partnerships.[16]

With respect to MWL, the form of the transaction as set out in the production order subcontract was completely ignored. Rather than creating a single large obligation running from Bard I to SSA, an independent entity, much smaller obligations were executed by Bard I in favor of individuals involved in the production. Further, these obligations were not evidenced by notes for over 2 years after the completion of the videotaping of Merry Wives.

In the case of MBL, a production order subcontract was never executed and, similarly to the MWL transaction, small obligations were executed in favor of individuals rather than executing a single large obligation in favor of the production company. This included the execution of notes by Bard II in favor of regular employees of the production company as compensation for their services as employees of the production company. More significantly, the first set of notes executed by Bard II clearly stated that amounts in excess of a pro rata portion of MBL's minimum interest payments would only be paid out of revenues from distribution. There is also testimony in the record indicating that this was the understanding of individuals who received notes with respect to both Merry Wives and Macbeth.

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[16] The record does not clearly show how much of the balance of the CFL and GMS notes might also have been ultimately obligated to Century, Solaris, or Syntar.

We also note that rather than have Century or Bard incur obligations to other parties based upon the partnerships' obligations, Scheer chose to interpose new corporations, funded with only $1,000 and created solely for this purpose, between each of the partnerships and any third party obligees. While this might not prevent a third party from reaching the partnership's obligation, it clearly has the potential of hindering such a party from doing so, especially where such party's claim is relatively small.

In sum, the record convincingly shows that the face amount of each of the notes was drastically inflated beyond an economically justifiable amount when considered in reference to the interest provisions of the note. The record also casts doubt on whether the parties intended to enforce the notes in accordance with their terms. These facts are further evidence that the transactions here under consideration were not structured with the intent of conforming to economic realities but rather were entered in order to obtain tax benefits.

3. *The Offering Memoranda*

The offering memoranda uniformly failed to make any representations about the fair market values of the videotapes or the income streams which could be expected to result from exploitation of the videotapes. Each of the memoranda, however, devoted in excess of 14 pages to the tax aspects of investment in the partnerships. In fact, the most direct statement made in the memoranda concerning the benefits which could be expected to result from an investment in the partnerships was "that the relative financial benefit of an investment in the partnership will generally depend substantially on the tax bracket of the investor." In addition, the portion of the memoranda which explained the requirement that the limited partners assume liability for a pro rata portion of the partnership notes was part of the section of the memoranda which explained the "at risk" rules. Sec. 465. The memoranda also noted as risk factors the lack of experience of almost everyone involved with the management of the partnerships, the production of the videotapes, and the distribution of the videotapes.

Viewing each of the memoranda as a whole, it is unfathomable that a reasonable person could believe that there was a basis for investing in the partnerships other than for the acquisition of tax benefits.

4. *Appraisals Received by Petitioner*

Merry Wives was the only production which petitioner had reviewed by an appraiser prior to entering into the acquisition agreement for the production. Because petitioner chose not to have Eliscu, the preparer of the appraisal report, testify as to his credentials and background, the report was offered at trial solely for the purpose of showing petitioner's due diligence in investigating the purchase of the videotape, and not as proof of the value of the videotape. The appraisal report, however, fails to show due diligence on the part of petitioner.

The report's explanation of the $5.1 million revenue projection is insufficient to justify reliance on it by any prudent investor. The stated basis consisted of vague assertions about market penetration and market growth, unsupported by relevant statistics or comparison to the results of similar productions. While purportedly relied on to justify a more than $2 million purchase, the report was only two pages and did not estimate the fair market value of the videotape. Further, petitioner has not alleged that the report was made available to investors, or potential investors, in MWL as a representation of the likely performance of the investment. We believe this to be indicative of petitioner's confidence in the report.

5. *Appraisals Prepared for Trial*

Respondent offered the reports and testimony of two experts who examined the four productions here under consideration. Respondent's expert James A. Sowards estimated the fair market values of each of the productions as of the dates that the acquisition agreement for each was executed. Sowards determined the following fair market values:

Production	*Value as of—*	*Value*
Memoirs	10/04/79	$179,728
Geppetto's	10/04/79	179,728
Merry Wives	12/31/80	152,755
Macbeth	10/21/81	152,755

Respondent's expert A. Frank Reel also valued each of the productions as of the acquisition dates. Reel determined the following fair market values:

Production	*Value as of—*	*Value range*
Memoirs	October 1979	$97,500 to $130,000
Geppetto's	October 1979	130,000 to 162,500
Merry Wives	December 1980	26,000 to 32,000
Macbeth	October 1981	25,000 to 35,000

Petitioner's expert on distribution of video products, Raymond Markman, testified as to the revenues that could be generated by the productions during the 5-year period following trial. Markman testified that each of the children's series could generate $4 million in wholesale home video revenues and $1 million in television revenues over the 5-year period. Markman testified that the Shakespearean plays would each produce $10 million in wholesale revenues over the 5-year period.

In evaluating the testimony of Markman, it is difficult not to reflect back on the performance of the productions and of the partnerships up to the time of trial. During the distribution periods prior to 1984, which ranged from 3 to 5 years for each production, the productions returned the following amounts of income to their respective partnerships:

Production	*Total income*
Memoirs	$5,000 to $10,000
Geppetto's	5,000 to 10,000
Merry Wives	0
Macbeth	3,000 to 4,000

During the years in issue, the partnerships generated the following tax losses:

Partnership	*Years*	*Total tax losses*
CFL	1979 to 1981	$1,650,256
GMS	1979 to 1981	1,470,901
MWL	1980 to 1981	1,063,103
MBL	1981	400,806

Nonetheless, we believe that it is unnecessary for us to attempt to resolve the conflicts which exist between the opinions of the experts and between these opinions and other evidence which has been presented. Petitioner has admitted to facts which clearly establish that the prices paid for the videotapes were substantially inflated. The record unambiguously shows that the terms of the purchases were the result of a complete lack of arm's-length dealings and that Scheer possessed control of the structuring of the transactions and the ongoing operation of the partnership. The record also calls into doubt whether the parties intended to enforce their agreements in accordance with the terms set out therein. The totality of facts and circumstances establish that the purchase transactions here in issue were in substance shams lacking economic significance beyond expected tax benefits. *Falsetti v. Commissioner*, 85 T.C. 332 (1985).

Accordingly, it is unnecessary for us to reach the remaining issues other than the applicability of section 6621(d).

B. Section 6621(d)

By an amendment to answer, respondent has raised the applicability of section 6621(d) to the portion of the underpayments attributable to the partnerships' basis overstatements.[17]

Section 6621(d) provides for an increase in the rate of interest payable under section 6601 with respect to a "substantial underpayment" (defined as an underpayment in excess of $1,000) attributable to a tax-motivated transaction.[18] Section 6621(d)(3)(A) enumerates types of transactions which are to be considered "tax motivated transactions." These transactions include "any valuation overstatement (within the meaning of section 6659(c))." Sec. 6621(d)(3)(A)(i). A valuation overstatement, within the meaning of section 6659(c), has occurred "if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)."

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[17] In his amended answer, respondent also raised the applicability of sec. 6621(d) to any portion of the underpayment attributable to "any loss disallowed by reason of section 465(a)." Sec. 6621(d)(3)(A)(ii). We did not reach the applicability of sec. 465(a) in this case, and because of respondent's failure to brief the applicability of sec. 6621(d), we will not consider its application beyond the narrowest scope raised in his amended answer.

[18] The provision is applicable to transactions entered into prior to its enactment, but the additional interest only accrues after Dec. 31, 1984. *Solowiejczyk v. Commissioner*, 85 T.C. 552 (1985), affd. without published opinion 795 F.2d 1005 (2d Cir. 1986).

Each of the partnerships here in issue claimed a basis in depreciable purchased property of $2.3 million ($2,320,000 in the case of MWL) and claimed deductions and investment tax credits as a result. Our holding that each of the purchases was in substance a sham is also a determination that each partnership's correct basis in the property was zero. As such, a valuation overstatement within the meaning of section 6659(c) has occurred to the extent of the full basis claimed by each of the partnerships, and the underpayments which are attributable to all deductions and credits resulting from the claim of basis in the purchased property are attributable to tax-motivated transactions. *Zirker v. Commissioner*, 87 T.C. 970 (1986). Further, for each of the years in issue, the underpayment resulting from petitioner's share of such deductions and credits is in excess of $1,000 and is therefore a "substantial underpayment." Application of the rate provided by section 6621(d) shall be made in the amount of the substantial underpayment determined pursuant to Rule 155 in accordance with Temporary Regulation section 301.6621-2T, Proced. & Admin. Regs., 49 Fed. Reg. 50391 (1984).

Accordingly, in order that the parties may calculate the portion of the underpayment to which section 6621(d) is applicable for each year in issue,

Decisions will be entered under Rule 155.

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